

Before the  
POSTAL REGULATORY COMMISSION  
Washington, DC 20268-0001

Statutory Review of the System  
for Regulating Rates and Classes  
for Market Dominant Products

Docket No. RM2017-3

INITIAL COMMENTS OF THE GREETING CARD ASSOCIATION

I. INTRODUCTION

The Greeting Card Association (GCA) files these Initial Comments, which include Appendices A-C, pursuant to Order No. 3673. GCA comprises about 200 greeting card publishers and related businesses, and is the only mailing industry association representing the interests of the individual household mail user.

Our Initial Comments begin (sections II and III) with observations on the kind of outcome the Commission should try to achieve in this Docket. First, the Commission should aim for a market-dominant regulatory system which will stand the test of time; it should be robust enough to effectuate the objectives and factors of the Act through possibly unpredictable changes in postal markets. Second, and at least equally important, the Commission must recognize the limits – unique to the postal setting – of what a system for regulating rates and classes for market-dominant products can be expected to do.

As required by Order No. 3673, we next address the substantive issues objective by objective (section IV). In the course of that discussion, we will emphasize two main features of the Postal Accountability and Enhancement Act (PAEA) – the price cap and the limitations on workshare discounts – which (i) are

of particular importance for the citizen mailer, and (ii) are, in GCA's view, not subject to abolition or substantial modification in this review. Our concentration on these two substantive areas means that we will not separately discuss those objectives having little or no connection with them.

Sections V and VI present our reasons for concluding that sec. 3623(d)(3) does not allow abolition or major change in either the price cap (section V) or the workshare discount limitations (section VI). In these comments, we frequently include discussion which ignores that conclusion for purposes of analyzing a problem; we generally signal that we are doing so. Section VII summarizes the historical development of the existing workshare discount system, showing that it has been consistent over the years and has focused – successfully – on creating and maintaining prices for workshared mail. Section VIII briefly draws together our conclusions and recommendations. Appendices A, B, and C form the final component of these Initial Comments.

## II. THE COMMISSION FACES A LONG-TERM RESPONSIBILITY

The Commission's work in this review will probably shape the fortunes and expectations of the entire postal community for many years. Unlike sec. 701 of PAEA, which calls for a report on the functioning of the system every five years, the review mandated by sec. 3622(d)(3) may well turn out to be a unique event. It is true that the Commission may repeat its review "as appropriate thereafter." But whether a proposed later "re-review" is appropriate is itself likely to be highly controversial – a preliminary obstacle we do not face in this statutorily mandated proceeding. Subsequent "as appropriate" revisits should not be counted on as an easy or reliable fix for any dysfunctional new features introduced in the present mandatory review.

Consequently, any changes the Commission does decide are needed should be neither based on nor justified by short-term or unstable conditions in the market-dominant sector. First, the objectives and factors set out in sec. 3622(b) and (c) are not subject to change in this review (or any subsequent

ones), and any changes in the system are required to promote them. Even a change based explicitly and securely on persistent, long-term changes in the postal market must obey that mandate. One based on transitory phenomena, or on disputable understandings of them, most probably will not. Secondly, a regulatory system repeatedly changed in response to unstable conditions or unreliable analyses quickly ceases to be a system. Instead, it can become, in Mark Harris's phrase, "The Exciting Game Without Any Rules."<sup>1</sup> As such, it would clearly be disqualified as inconsistent with sec. 3622(b)(2), which requires the system "to create predictability and stability in rates."

### III. THE MARKET-DOMINANT RATEMAKING SYSTEM SHOULD NOT ATTEMPT TO SOLVE FINANCIAL PROBLEMS UNRELATED TO MARKET-DOMINANT SERVICE

Before addressing the individual objectives, we offer observations on what a market-dominant ratemaking system, in the context of the Postal Service, should be expected to do.

#### A. Market-dominant products and costs are only part of the story

We begin, briefly, with a point which is no doubt obvious. The Commission's assignment under sec. 3622(d)(3) is to review the ratemaking system established under sec. 3622(a) for market-dominant products. The Commission has limited this review to sec. 3622.<sup>2</sup> Necessarily, therefore, it must take account of the effect on the Postal Service and its market-dominant customers of the growing competitive-side business. In FY 2016, competitive products accounted for 27 percent of the Service's revenues and 30 percent of its attributable costs.<sup>3</sup>

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<sup>1</sup> See Mark Harris, *Bang the Drum Slowly* (New York: Knopf, 1956).

<sup>2</sup> Order No. 3673, pp. 2-3, 11.

<sup>3</sup> Docket ACR2016, *Public Cost and Revenue Analysis, Fiscal Year 2016*.

As sec. 3633 makes clear, market-dominant product users cannot be made responsible for these costs, nor for the entirety of the Service's institutional costs.<sup>4</sup>

## B. The need to distinguish controllable from non-controllable costs

### 1. The unique situation of the Postal Service must be taken into account

A basic question in reviewing the sec. 3622 system is "What costs should the ratemaking system be designed to recover?" At first it might seem that the correct answer is "All of them." But analogies from regulatory practice in the private sector – where such an answer might seem intuitively right – can be misleading. This is so because we naturally assume that all the costs of a regulated commercial enterprise are incurred to serve its customers, so that (absent a showing that in a particular case this is not so<sup>5</sup>) we correspondingly assume that they should be recovered *from* customers.

*Unique status of the Postal Service as a regulated Federal establishment.* As an independent establishment of the Executive Branch of the government (39 U.S.C. sec. 101(a)), the Postal Service faces requirements not normally imposed on private-sector enterprises, even those otherwise subject to regulation. The most prominent example for the postal community is of course the PAEA mandate to prefund retiree health benefit (RHB) costs on an unworkably compressed schedule – one which finds no analogy in the private sector or in other areas of government.<sup>6</sup> Since FY 2011, an average of \$5.65 billion has been thus added

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<sup>4</sup> Which sec. 3622(b)(9) requires be appropriately allocated between market-dominant and competitive products.

<sup>5</sup> Examples: Utility A attempts to include costs of its non-utility businesses in the cost of service for utility customers; Utility B claims a cost for an admittedly utility-related purpose which is nevertheless shown to be unreasonably high and thus (i) imprudently incurred within the meaning of the applicable regulatory statute, and hence (ii) not a proper cost of serving customers.

<sup>6</sup> It would be a useful thought experiment to hypothesize a private-sector utility, subject to cost-of-service rate regulation, which undertook to pre-fund its retirees' health benefits on a schedule like that imposed by Congress on the Postal Service – rather than one close to private industry norms – and to recover the cost of doing so from ratepayers. Would such an initiative be likely to survive a prudence inquiry by the regulator?

to the Service's obligations each year. Appendix A, a study prepared by NDP Analytics, shows that it is this unique, non-operational obligation which drives the Postal Service's balance sheet deficits. It is widely recognized that the RHB pre-funding requirement stems from Federal budgetary concerns, and bears no discernable relationship to the Service's cost of serving its customers.<sup>7</sup>

If the basis of a ratemaking system is full cost recovery – that is, if it instantiates a cost-of-service regulatory model like the one superseded by PAEA – this distinction may have less significance. But if the legislature has opted for incentive regulation, as Congress did in 2006, it is centrally important.

*Impossibility of providing an incentive to control non-controllable costs.* If the ratemaking system is designed to motivate management efforts to improve productive efficiency, then it is, more or less by definition, aimed at *controllable* costs. It follows that a cost which management cannot control is one which a particular ratemaking technique cannot help reduce. If, as here, a substantial cost element has been legislatively imposed, in specific dollar amounts, management efforts cannot lower it. In objective (b)(1) terms, this situation cannot be

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<sup>7</sup> In presenting its financial picture, the Postal Service commonly lumps the RHB pre-funding obligation in with its operating expenses. It states that to conform to GAAP it must include them in operating expenses "regardless of whether the obligations are paid." See the Service's *FY 2016 Report on Form 10-K*, p. 58. True as this may be – and perhaps helpful as an indication of its *overall* financial status – it is not a good basis for deciding what we should look for from a rate-making system. A set of GAAP is meant to reflect this overall condition, with an appropriate degree of conservatism. Whether a ratemaking system is working satisfactorily is better judged by examining operating revenues and expenses presented more nearly as the Service shows its "controllable income," and here the picture is considerably more encouraging. See, e.g., the Postal Service's *FY 2016 Report on Form 10-K*, p. 15. The table there shows the Service's "Non-GAAP Controllable Income." The Service's description of this metric is worth quoting *in extenso*:

In the day-to-day operation of our business, we focus on costs within our control, such as work hours and transportation. We calculate controllable income, a non-GAAP measure, by excluding items we cannot control, such as PSRHBFB expenses, workers' compensation expenses caused by actuarial revaluation and discount rate changes, and adjustments for non-recurring items, such as the change in accounting estimate for *Deferred revenue-prepaid postage*. Controllable income should not be considered a substitute for net income and other GAAP reporting measures. . . .

The table in the FY 2016 10-K, which includes non-controllable items besides PSRHBFB pre-funding, shows controllable income of \$610 million, \$1,188 million, and \$1,357 million in FY 2016, 2015, and 2014, respectively. For further discussion, see Appendix A, and particularly Table 3.1, which presents financial results without the RHB pre-funding element.

changed by an incentive to “reduce costs and increase efficiency.” The *total* cost of the enterprise can be reduced by pro-efficiency initiatives elsewhere, and the exogenous price cap is a proven way of bringing this about.

The controllable/non-controllable distinction was helpfully used in a report by the Postal Service’s Inspector General: *Peeling the Onion: The Real Cost of Mail*, RARC-WP-16-009 (April 18, 2016). The IG found that if non-controllable costs – here, the RHB prefunding obligation and workers’ compensation costs – are excluded, inflation-adjusted labor expenses fell by \$10.2 billion since 2006, and total expenses by \$13.7 billion. The IG was not discussing the choice of ratemaking models, but the controllable/non-controllable distinction is equally central to the issues the Commission faces here. If the question is whether the existing price cap model remains optimal, it is important to limit that question to the controllable cost sector. The analyst evaluating the success of a system should (i) avoid counting against it failures to improve situations which it inherently could not affect, and (ii) recognize that there may be effective ways of alleviating those problems which the ratemaking system cannot reach.

## 2. Why Not a Full Cost Recovery Approach?

A hypothetical opponent of this view might point out that, while our argument is valid for an incentive-oriented ratemaking model, that model is not the only one available. (In pursuing this question, we are bracketing our conclusion, explained below (section V), that Congress has made a price cap mandatory in any ratemaking system devised by the Commission, both initially and in the present review process.) A traditional cost-of-service<sup>8</sup> approach could overlook the controllable/non-controllable distinction because it aims, primarily, to maintain the financial viability of the (presumably indispensable) enterprise.

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<sup>8</sup> We are using “cost-of-service” as synonymous with “full-cost-recovery,” so as to avoid semantic puzzles over whether a cost not necessary to serve customers (i.e., extreme RHB pre-funding requirements) is really a cost “of service.”

The (equally traditional) objection to cost-of-service ratemaking is that it fails to create incentives for productive efficiency, and indeed is likely to have the opposite effect. In capital-intensive private-sector industries, it is often thought to incentivize overinvestment, since, barring a regulatory finding of imprudence, rates are set to produce a competitive return on invested capital (the Averch-Johnson effect). This may not be a top-level problem for the labor-intensive Postal Service, but the failure of cost-of-service regulation to motivate improvements in productive efficiency would be felt in other areas (underutilization of employees, retention of unneeded facilities which still must be staffed, a suboptimal mix of full- and part-time personnel, etc.).

Adopting a cost-of-service model would thus amount to deciding (i) that the ratemaking system must cure all the financial problems of the Postal Service – those created by Congress, for reasons extrinsic to the needs and concerns of the postal community, as well as those resulting from the public's consumption of postal services, and (ii) that incentives to productive efficiency are unimportant. That decision would be wrong in principle, and would hinder or prevent achievement of PAEA's objectives (most obviously, objective (b)(1)).

### 3. The efficiency function of postal prices

One function of a ratemaking system is to generate useful price signals, so that potential consumers can decide how the utility of the good or service on offer compares with its price. If the consumer's utility exceeds the price asked and (s)he buys the article, total welfare is increased. For this to be reliably true, however, the price must bear a reasonable relation to the quantity of resources the vendor expends to produce the article.

If the price is inflated artificially, as, for example, by including an increment to allow the vendor to pay an expense not reasonably necessary to produce the article or service, consumption which could increase total welfare will be discouraged. That is an additional reason why, in the present case in which the Postal Service bears very large annual RHB funding obligations quite unrelated to the

reasonable cost of providing its services, the cost-of-service model would be inappropriate. A prefunding schedule like that imposed on the Postal Service is simply not found in other enterprises or government entities, and the annual cost resulting from it cannot reasonably be treated as an ordinary cost of doing business. That is why its inclusion in a ratemaking system would count as “artificial.”

Summarizing: In considering changes to the market-dominant regulatory system, the Commission should (i) take appropriate account of the role, both contemporaneous and reasonably foreseeable, of the competitive sector in improving and maintaining the Postal Service’s financial stability, and (ii) not attempt to make market-dominant customers responsible for costs unrelated to provision of the service they buy.

#### IV. HOW DOES THE PRESENT SYSTEM MEASURE UP TO THE OBJECTIVES?

##### A. Objective 3622(b)(1) – To maximize incentives to reduce costs and increase efficiency: the price cap

The fundamental purpose of a price cap like that required by sec. 3622(d)(1)<sup>9</sup> is to motivate the regulated enterprise to operate efficiently and to reduce its costs. Congress selected this model to replace a cost-of-service rate-making system which explicitly guaranteed breakeven (subject to the “honest, efficient, and economical management” standard of former sec. 3621).

*What do we mean by “efficiency?”* A basic question here is what sec. 3622(b)(1) requires us to look for when evaluating the system’s ability to increase efficiency. In GCA’s view, promoting “efficiency” should be taken to include not just reducing the unit cost of operations or the carrying cost of investments (“productive efficiency”) but also constructing a set of prices which improve both consumer and producer surplus. We discussed the second of these concerns, in

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<sup>9</sup> Section citations standing alone refer to title 39, United States Code.



more general terms, in section III.B.3 above. The most evident effect of the price cap, however, is on productive efficiency.

The practical results of the price cap show that it should be retained. Having moved away from a misleading focus on total obligations, non-controllable as well as controllable, we can see that the PAEA price cap has been notably successful.

*Past findings as to results.* In Orders No. 547 and 1926, in the sec. 3622(d)(1)(E) exigency case, the Commission evaluated the Postal Service's achievements in cost reduction. Its conclusion was that under the price cap the Service had largely succeeded in achieving Objective (b)(1):

Price cap rate regulation was expected to promote several goals, including, importantly, to incent the Postal Service to reduce costs and increase efficiency. Of late, in particular, it has done a commendable job. In FY 2009 alone, the Postal Service has reduced costs by \$6 billion. [Order 547, p. 80]

[Figure 1] shows that in FY 2007, the Postal Service succeeded in cutting workhours faster than volume declined. It was not able to match that success in FY 2008 and FY 2009. In FY 2010, however, the Postal Service has again succeeded in reducing workhours faster than volume has declined. This is a promising development, indicating that in response to volume declines, the Postal Service is moving to reorganize its workforce over time to better match its workload. [id., p. 82]

(We should note that FY 2008 and FY 2009 – the “Great Recession” years<sup>10</sup> – saw the most drastic volume declines in the period the Commission reviewed.) See also the discussion of the favorable total factor productivity results at p. 86 of Order 547, and Order 1926, pp. 131 et seq.

The OIG's *Peeling the Onion* report, cited above, shows how successfully the Postal Service has controlled those costs which it can control. Fig. 2, on p. 6 of the report, shows that the three major cost groupings – labor, non-labor, and capital – declined an average of 2.6, 1.2, and 3.9 percent respectively between FY 2006 and FY 2015. The OIG's explanation of fig. 3, on p. 7, is worth quoting:

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<sup>10</sup> According to the National Bureau of Economic Research, the recession began in December 2007 and ended in June 2009. See Order 1926, p. 82, fn. 72.

Breaking out retiree healthcare obligations that are unrelated to current production shows that the Postal Service has decreased its labor expenditures by about \$10.2 billion since 2006. *Our analysis shows that there were indeed labor cost savings, but those entire savings were masked by RHB prefunding obligations over the last 9 years.* [Italics added.]

GCA has previously acknowledged that how far these successes are due to the price cap and how far to management's independent efforts may be "unknowable," but there is no reason to believe that the cap was not a main contributor.<sup>11</sup> One important advantage of the cap is that it is a constant presence in management thinking. Particular cost-reduction programs may have a defined life-span, and can be re-configured or even canceled during it, but the cap is a persisting incentive to improve cost efficiency.

*Relationship to other Objectives.* This discussion has focused on how the existing price cap has helped achieve objective (b)(1), and why it is superior, in this respect, to the principal competing ratemaking model – cost-of-service (or full cost recovery). Whether it also promotes the adequate revenue objective will be discussed in connection with that provision, but there too the controllable/non-controllable distinction emphasized here must be kept in mind.

B. Objective 3622(b)(1) – To maximize incentives to reduce costs and increase efficiency: workshare discounts.

*Efficient price structures under the PAEA ratemaking system.* The efficiency of Postal Service prices is promoted not just by the cap but also by the limitations sec. 3622(e) imposes on workshare discounts. For reasons discussed

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<sup>11</sup> Docket PI2016-3, *Comments of the Greeting Card Association*, p. 3. It is not even clear that there are bright lines separating cost reductions directly compelled by the price cap, those motivated by a recognition that *at some future point* the cap might compel them, and those undertaken simply because they appear to be sound management moves (in other words, those which would probably have been undertaken by ideally conscientious managers even under a cost-of-service regime).

below (section VI), GCA believes that these limitations are, like the price cap, legally insulated from abolition or substantial change in this review. In this section, we again bracket that conclusion and proceed as if they were fully subject to change. In this discussion, we will be concerned with both productive and allocative efficiencies.

Our first point is that “[t]o maximize incentives to reduce costs and increase efficiency” does not mean “to make workshare discounts as large as possible.” It is true that a properly-designed workshare discount is an incentive to reduce costs, and may turn out to be, also, an incentive to maximize efficiency.<sup>12</sup> But, as the Commission has been emphasizing for many years (see the discussion in section VII, below), the “cost” to be “reduced” is the *combined* cost of a bulk mailing.<sup>13</sup> A discount exceeding avoided cost results in the mailer performing work the Postal Service could perform more cheaply, and the result is to *prevent* achievement of the lowest combined cost for the mailing. Similarly, the incentive is meant not only to reduce costs but also to increase efficiency. An incentive which raises the cost of a mailing above the lowest achievable level is pretty clearly not increasing efficiency. The cost reduction/efficiency objective, therefore, is best effectuated by the kind of pricing rules embodied in sec. 3622(e).

Given the Postal Service’s need, now and for the foreseeable future, to use essentially all the pricing authority the cap affords it, inefficient overcompensation of worksharing will entail a net sacrifice of revenue which must be made up by non-worksharing mailers. Because demand for non-workshared mail is not inelastic, users of that mail type will reduce their usage, entailing a sacrifice of consumer surplus as to them, thereby reducing allocative efficiency.

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<sup>12</sup> It can cease to be a pro-efficiency incentive if changes in Postal Service operations make the worksharing involved counterproductive, as became true of First-Class Carrier Route Automation Letters (see PRC Op. R2006-1, ¶¶ 5176, 5179).

<sup>13</sup> A different interpretation could be reached only by reading “reduce costs” to mean “reduce the Postal Service’s costs without regard to effects on other costs.” Nothing in the statutory language requires that reading, and everything in the statute’s pre-history tells against it. (On this pre-history, see section VII, below.)

*The theory behind these efficient structures and the statutory rules that reflect it.* The workshare discount limitations of sec. 3622(e) are not an arbitrary enactment but an embodiment of sound economic principles. The Commission has developed and refined this theory over most of the history of postal regulation. Section VII, below, presents that historical development as helping demonstrate the soundness of the theory and the reasons why it should not be abandoned.

C. Objective (b)(2) – To create predictability and stability in rates: the price cap

Sec. 3622(b)(2) requires the regulatory system to produce stable and predictable rates. Two aspects of the price cap regime are particularly relevant. The CPI-U cap itself clearly promotes this objective. The current rate of inflation and the 12-month moving average, as calculated by the Commission's published formula, are easily available to the mailing community, so that mailers can predict class-level price increases with reasonable assurance.

That the cap is applied class-by-class also promotes objective (b)(2). The wider the scope of the cap, the greater the possible range of variation in price increases, both across the system in a given year and from year to year within one class. In our Comments in Docket PI2016-3, we gave a simplified example of how violently rates could gyrate under a system-wide cap.<sup>14</sup> Application of the cap at the class level thus favors both stability and predictability.

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<sup>14</sup> Docket PI2016-3, *Comments of the Greeting Card Association*, p. 4 (fn. omitted):

A system-wide price cap would substantially increase the range of variation possible for each class. Consider a highly simplified example: Assume (i) a system with only two classes, First Class and Standard Mail, (ii) a two-percent price cap in the test year, fully utilized and with no banked authority available, and (iii) no volume effects. On the basis of FY 2015 revenues and volumes, the existing class-level cap would allow, for the whole system, a revenue increase of \$942.6 million. The existing rules would of course allow a two-percent increase for each class. With a system-wide cap, however, the limit cases are a 3.20 percent increase for First Class and a 5.32 percent increase for Standard.

(The "limit cases" are those in which one of the two classes receives no increase.)

The statute also requires the CPI-U as the index underpinning the cap. It might be the case that a different index would not degrade the effectiveness of the system as regards stability and predictability; this issue, however, is better taken up under objective (b)(5) (adequate revenue). See section IV.H. (pp. 20 et seq.), below.

A third benefit from the PAEA system is the existence of a regular schedule of rate adjustments. This benefit can be seen by comparing pre- and post-PAEA adjustment intervals. Table A on the next page shows these intervals (as they affected the letter stamp); those occurring after enactment of PAEA are shaded in tan, and those before in blue. Under the 1970 PRA, they ranged from seven to 48 months. Including Docket R2006-1, decided after enactment of PAEA but under PRA procedures, those under the present system ranged from ten to 33 months. Excluding, in each case, the shortest and longest intervals, the respective ranges were still markedly different: 18 to 47 months and 12 to 16 months, respectively.<sup>15</sup>

#### D. Objective (b)(2): To create predictability and stability in rates: workshare discounts

##### 1. A known principle for workshare discounts promotes predictability

Under sec. 3622(e), workshare discounts are governed by a basic rule – efficient component pricing – which the Commission has developed over several decades. The postal community is familiar with it. Disagreements remain, but by and large they concern what should be recognized as cost avoidances justifying a discount, or how well the Postal Service is living up to the (ideal) standard of discounts passing through 100 percent of avoided cost. The Commission clari-

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<sup>15</sup> It is worth noting that the seven-month interval in the pre-PAEA period resulted from there being two different sets of rates in a single docket (R80-1), those recommended by the Commission in the first instance, and those implemented following modification by the Governors. Consequently, there was no on-the-record hearing between the two.

fied, in Orders 536 and 1320, what features would and would not qualify for inclusion in the cost base governing a discount. To discard this basic rule would therefore greatly increase uncertainty, not only for mailers who use the discounted categories but, given the current financial condition of the Postal Service, those who use non-workshared categories in the same price-capped class.

TABLE A. INTERVALS BETWEEN RATE CHANGES (FIRST OUNCE LETTER RATE)

RATE CHANGE	INTERVAL (MONTHS)
(Legislated - 1968)	
5/16/1971	41
3/2/1974	33
12/31/1975	22
5/29/1978	29
3/22/1981	34
11/1/1981	7
2/17/1985	40
4/3/1988	37
2/3/1991	34
1/1/1995	47
1/10/1999	48
1/7/2001	24
6/30/2002	18
1/8/2006	42
5/14/2007	16
5/12/2008	12
5/11/2009	12
1/22/2012	12
1/27/2013	12
1/26/2014	33
4/10/2016	12
1/22/2017	10

## 2. A possible improvement

In Docket No. ACR2016, Presort First-Class users suggested a possibly useful improvement in the treatment of workshare discounts.<sup>16</sup> They pointed out that cost avoidances reported by the Postal Service can fluctuate substantially from year to year, implying that the theoretically desirable 100 percent passthrough would fluctuate similarly. Since the Postal Service reports these avoidances at the end of a calendar year, with the rest of its compliance materials, worksharing mailers do not receive much notice of the maximum possible discount permissible. The cited commenters proposed using a three-year moving average of avoidances to smooth out these fluctuations.

Their proposal seems attractive from the viewpoint of objective (b)(2). Using a three-year average, as the Presort users suggest, would mean that much of the cost avoidance information potentially affecting the discount would already be known. GCA has not speculated about possible disadvantages, but believes that it still would be worthwhile for the Commission to consider it in this review.

### E. Objective (b)(3) – To maintain high-quality service standards: the price cap

*There is no empirical support for a connection between price-cap regulation and deterioration in service.* It has been suggested that price cap regulation may have the unwanted effect of motivating reductions in service, or service quality, rather than efforts to reduce unit costs. This proposition might seem *theoretically* attractive, but it would need empirical support before it could be considered as a ground for changing the price cap.

Appendix B, a study prepared by NDP Analytics, shows that such empirical support is simply not there. Particularly because other PAEA provisions, not falling within the present review, provide for oversight of service quality, the service quality objective provides no support for changes to the price cap.

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<sup>16</sup> Docket ACR2016, *Comments of the Major Mailers Association, National Association of Presort Mailers, and the National Postal Policy Council*, pp. 6 et seq.

*If not the price cap, what?* The fact remains that service quality issues persist, and that the Postal Service has proposed and sometimes implemented reductions in service standards. A few years ago it launched a plan to end Saturday delivery, a project apparently now abandoned. Subsequently, it implemented a mail processing network rationalization scheme which, among other things, eliminated overnight delivery for local Single-Piece First-Class Mail and severely limited the availability of that service level for Presort.

This last case provides a useful illustration. In Docket N2012-1, the Postal Service's financial witness, Stephen J. Masse, Vice President, Finance and Planning, explained the financial context of the proposal.<sup>17</sup> The main theme of his presentation was that declining mail volume had led to excess processing capacity. The processing network realignment, which the Service said would involve reduced service quality<sup>18</sup>, was expected to save \$2.1 billion a year. Mr. Masse's testimony referred only in passing to the price cap<sup>19</sup>, and placed the main responsibility for the financial situation on volume declines and legislatively imposed payment obligations. These are both non-controllable elements, neither of which would be affected by changing the ratemaking model.

#### F. Objective (b)(4) – To allow the Postal Service pricing flexibility: the price cap

*What do we mean by “pricing flexibility?”* Sec. 3622(b)(4) can be construed in two ways – distinct, though perhaps not mutually exclusive. “Flexibility,” in this context, may have a procedural focus: the Postal Service should be free to

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<sup>17</sup> Docket N2012-1, USPS-T2.

<sup>18</sup> The Commission did not agree that the proposed service reductions were necessary. See PRC Op. N2012-1, pp. 45-46.

<sup>19</sup> USPS-T2, p. 5; at pp. 9-10, Mr. Masse stated that

Likewise, increasing prices significantly to offset the decline in volumes would be insufficient, as it would likely require approximately \$5 billion in new revenue, or an eight percent increase over 2011 revenues. To put such an increase in perspective, \$5 billion of new revenue is the equivalent of growing an entire Fortune 500 company in one year, from scratch.



adjust prices quickly, with only minimal ex ante oversight, in response to changes and opportunities in the marketplace. This aspect of “flexibility” is not restricted by the price cap.

Pricing flexibility can, alternatively, be read as relating to revenue. On this reading, “flexibility” would imply the ability to raise or lower rates with a minimum of *quantitative* limits; it would not entail a quick process or one relatively free of pre-implementation review.<sup>20</sup>

GCA believes that the focus of sec. 3622(b)(4) is on procedural flexibility and, to a significant extent, on which institution is to make pricing decisions. This view is supported by the overall structure and purpose of PAEA. Most obviously, interpreting “pricing flexibility” in the second sense would conflict with the price cap. Congress should not be assumed to have tried to combine a specific, exogenous limitation of revenue – the CPI-U price cap – with an objective looking toward freedom to raise as much revenue as possible. In addition, another objective, sec. 3622(b)(5), provides for adequacy of revenue (including retained earnings). Reading sec. 3622(b)(4) as concerning overall revenue would imply, unreasonably, that two separately expressed objectives have the same purpose, making one of them redundant.

Similarly, other provisions of sec. 3622 clearly aim at procedural flexibility. Sec. 3622(d)(1)(C) requires the Commission to finish its review of new rates in 45 days. Sec. 3622(d)(2)(C) adds flexibility to take advantage of unused cap space, so that the Postal Service is not put in a “use it or lose it” situation.

The Commission’s observations in Order No. 43 are helpful here. Addressing a sharp divergence in the comments over the level of public participation required in sec. 3622(d) rate reviews, the Commission said:

[2025] . . . The Commission concludes that one of Congress’s main motives in enacting the PAEA was to simplify and expedite the setting of postal rates. It further concludes that Congress intended to give the Postal Service wide latitude in designing specific rates and rate relationships, expecting that the Commission would alter those decisions only

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<sup>20</sup> It seems reasonable to suppose that, as limits on price increases were made looser, more elaborate oversight mechanisms would be called for.

where disregard of particular statutory standards is clear. Consequently, the Commission now plays a different role in reviewing proposed rates prior to their implementation than it has in the past.

[2026] The Commission also concludes that Congress expected that a modern system for regulating rates and classes would afford the public and the Commission only a limited period of pre-implementation comment and review. . . . [Section 3622(d)(1)(c)] indicates that Congress viewed 45 days as an adequate review period for the compliance issues that would be raised prior to implementing new rates. This implies that the pre-implementation issues with which Congress expected the Commission to deal would be few enough, or the level of scrutiny would be light enough, to allow the Commission to evaluate them adequately within 45 days. . . .

Measured by this standard, the existing price cap has succeeded in providing pricing flexibility. First, we should recall that because PAEA has largely substituted ex post for ex ante rate review, the Postal Service can now adjust rates annually. Under the 1970 Postal Reorganization Act, a rate case took a minimum of ten months<sup>21</sup> for Commission action, some additional time for the Governors to adopt the recommended decision (if they did), plus further lead time for implementation. Generally, the rate cycle lasted about three years. The present system thus greatly increased the Service's flexibility in terms of more frequent adjustments to meet changing market and operational conditions.

Secondly, the present system transfers from the Commission to the Postal Service the first responsibility for applying the pricing principles now appearing as factors in sec. 3622(c). The rule now is that a pricing decision by the Service stands unless the Commission finds – normally after the fact – that it actually violates a statutory provision or implementing regulation.

*Pricing flexibility in conjunction with other objectives.* Sec. 3622(b) requires that the objectives be “applied in conjunction with the others.” Doing so in this context calls for balancing of objectives (b)(4) and (b)(2). Unlimited pricing flexibility would inherently conflict with stability and predictability of rates. PAEA

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<sup>21</sup> The ten-month limit was added in 1976 (Pub. L. 94-421); the first two rate cases (Dockets R71-1 and R74-1) had taken substantially longer.

achieves a reasonable balance between the two by making the cap separately applicable to each class of mail.<sup>22</sup>

G. Objective (b)(4): To allow the Postal Service pricing flexibility: workshare discounts

Whether the existing system of workshare discounts conflicts with objective (b)(4) – and if so what should be done about it – has already engaged the Commission’s attention. In Docket RM2009-3, Order No. 536 at p. 37, it said that

How to resolve the tension between allowing the Postal Service pricing flexibility and ensuring that prices are cost minimizing is a core issue in this docket. Which standard or set of standards should prevail over the rest is not a matter to be resolved through *a priori* assumptions about which ones Congress made pre-eminent over others. The circumstances of each case should determine the relative weight that should be given to each. *However, under accepted rules of statutory construction when a general, qualitative pricing standard, such as pricing flexibility, conflicts with a specific quantitative pricing standard, such as the limit on workshare discounts, the pricing standards that are specific and mandatory should prevail over those that are general and discretionary.*<sup>[23]</sup>

The proposition we italicize would be true whether or not our conclusion that the workshare limitations are *statutorily* immune to modification in this procedure is accepted. But it does not mean that sec. 3622(e) deprives the Postal Service of adequate flexibility. While it enacts a general governing principle for workshare discounts, it also provides generous exceptions (secs. 3622(e)(2)(A) – (D) and (3)), enabling the Service to respond to both operational issues (especially subsec. (e)(2)(A)(ii) and (e)(2)(D)) and effect on workshared mail users. In addition, sec. 3622(e) does not enact all of the efficient component pricing principle the Commission has long followed; it establishes a ceiling for such discounts, but not

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<sup>22</sup> PAEA as enacted thus provides more pricing flexibility than if the House bill’s provision, which made the cap applicable at the subclass level, had found its way into the final legislation. See 109<sup>th</sup> Cong., H.R. 22, sec. 201.

<sup>23</sup> Order 536, p. 37 (fn. omitted; italics added).

a floor. Sec. 3622(e) thus provides a very substantial degree of flexibility in the setting of workshare discounts. In Order 536, the Commission explained that the legislated rules in sec. 3622(e) set the bounds for the exercise of sec. 3622(b)(4) pricing flexibility, and not the other way around.<sup>24</sup>

H. Objective (b)(5): To assure adequate revenues, including retained earnings, to maintain financial stability: the price cap

In considering this objective it is important to be clear about what “adequate revenue” means in the context of this review. In section III.B., above, we discussed the structural limitations – clearly relevant to this question – on what a market-dominant ratemaking system can be expected to do. The Commission should not take the statutory phrase to mean revenue adequate to meet all the Postal Service’s obligations, regardless of their relation, or lack of it, to serving postal customers, or to require a price index closely tracking the Service’s actual expenditures.

1. The Postal Service’s contentions

The Postal Service has suggested that the price cap interferes with revenue adequacy. For example, at p. 8 of its FY 2016 Form 10-K report, the Service states, under Risk Factors, that

. . . PAEA generally limits price increases on our market-dominant services to the rate of inflation as measured by the CPI-U. However, our costs are not similarly limited. A large portion of our cost structure cannot be altered expeditiously, and the number of our delivery points continues to grow. Accordingly, we may not be able to increase prices sufficiently to offset increased costs.

Similarly, at p. 4 of the Service’s *Annual Report to Congress* for FY 2016:

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<sup>24</sup> Id., pp. 35, 36. The Commission also observed (id., p. 7) that “the nature and extent of the flexibility available in enforcing the workshare discount limit was comprehensibly addressed by Congress in the exceptions that it incorporated into section 3622(e).”

The Postal Service is also subject to a rigid price cap not faced by private companies. That cap is limited solely to the changes in consumer inflation, which does not reflect the realities of our business. This price cap severely limits our ability to raise necessary revenue to cover the rising costs of universal service, which continue to be incurred even as First-Class Mail volume declines.

The second quoted passage raises a significant question when the Postal Service contends that the cap “does not reflect the realities of [its] business.” First, among the most striking “realities” of the Service’s business is the increasing importance of competitive products, which are unaffected by the cap. The Service has been notably successful both in maintaining or growing its competitive business and improving its profitability (as the sec. 3633(a)(3) “minimum share” results reported in successive ACR dockets demonstrate).

Even if we take the Postal Service’s observation as referring only to its *market-dominant* business, the limit case of a price index which would “reflect the realities” of a firm’s business is one replicating in every respect the firm’s own profile of costs – in other words, a cost-of-service (full cost recovery) standard, which we showed earlier would fail to advance objective (b)(1).<sup>25</sup> In general, the more closely the price index comes to replicating the firm’s own cost profile, the less incentive to efficiency and cost reduction it provides.

Here again, therefore, we emphasize that the revenue objective, like all the rest, must be applied in conjunction with the others; in this context, the most evident need for accommodation is between it and the efficiency/cost-reduction mandate. To modify the price cap to reflect more nearly the “realities” of the Postal Service’s business would be to ignore the purpose of sec. 3622(b)(1), which is to promote favorable changes in those realities.

## 2. The controllable/non-controllable dichotomy once again

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<sup>25</sup> There may of course be other conceivable indices which would not map one-for-one onto a full-cost-recovery regime. The Service referred to one in its comments, attached to the Commission’s 2011 *Section 701 Report* (September 22, 2011), pp. 18-19.

In section III (pp. 4 et seq.), above, we discussed the importance of distinguishing between controllable and non-controllable costs in deciding what the market-dominant ratemaking system should seek to achieve. It is important here too. If the Commission considers changing the existing price cap<sup>26</sup>, it should reject *in limine* any modifications which would dilute the incentive to control those costs which can be controlled. Any modification it considers should be aimed solely at problems which postal management *cannot* alleviate.

3. Statutory mechanisms for revenue assurance must be considered as a whole

For any enterprise, revenue deficiencies may have either long-term or transient causes. The distinction is important here, since sec. 3622(d) provides a separate mechanism for some transient cases. The existence of the sec. 3622(d)(1)(E) exigency provision shows that the price cap is not meant to deal with them. This fact, in turn, indicates that the “retained earnings” aspect of sec. 3622(b)(5) should not be read as insuring against revenue shortfalls resulting from the “exceptional or extraordinary circumstances” specified in sec. 3622(d)(1)(E).<sup>27</sup>

I. Objective (b)(5): To assure adequate revenue, including retained earnings, to maintain financial stability: workshare discounts

1. Assuring adequate revenue entails avoiding needless revenue sacrifices

Our discussion (section IV.B., pp. 10 et seq.) of the workshare discount limits as they affect objective (b)(1) is relevant here. Discounts greater than the

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<sup>26</sup> Here, as elsewhere in these comments, we are bracketing, for purposes of discussion, our conclusion that the statute does not allow for abolition or major change in the price cap.

<sup>27</sup> Since, in GCA’s view, the price cap is immune to abolition or major change in this proceeding, the same is true of the exigency provision, which is likewise a “requirement.”

cost avoided by the worksharing concerned amount to an unnecessary sacrifice of revenue, and thus interfere with achievement of objective (b)(5). It is important to recognize that such a discount *necessarily* results in a loss of revenue on each over-compensated piece. If a two-cent discount is granted for worksharing which demonstrably saves the Postal Service only one cent, this loss is simply a matter of arithmetic.

## 2. Inflating discounts in the hope of increasing volume is too risky

It is sometimes argued that increasing discounts<sup>28</sup> will increase Postal Service revenue by encouraging greater volumes of “efficient” workshared mail. For this to be true, it would also have to be true that the mail in question was sufficiently price-sensitive for increases in its volume to outweigh the (mathematically inevitable) loss of revenue from over-compensating worksharing. Propositions about the own-price elasticity of postal products are notoriously controversial, and the results of the Postal Service’s volume estimation studies vary substantially from year to year. (On this topic, see Appendix C, another study prepared by NDP Analytics.).<sup>29</sup> It is also difficult to pin down the non-price factors responsible for changes in the volume of a postal product. In this connection, believe our section II, above, urging the Commission to avoid making systemic changes on the basis of “short-term or unstable conditions” is highly relevant.

In addition, the Postal Service can modify rates for workshared categories otherwise than by distorting their discounts, and if it reasonably believes that moderating workshare prices will improve net revenue it can do so by adjusting the cost coverage of the parent class.

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<sup>28</sup> Here we should distinguish between raising a discount *to* the avoided-cost level (which is not objectionable from the efficient-pricing standpoint), and raising it *above* that level (which is).

<sup>29</sup> The Commission has observed that there is no consistent pattern in which Presort is always more price-sensitive than Single-Piece. Order 536, pp. 13 (particularly fn. 6), Table 1 (p. 55), and 56-57.

J. Objective (b)(6): To reduce the administrative burden and increase the transparency of the ratemaking process: the price cap

1. The same features that make price-capped rates more predictable likewise make the process simpler and more transparent

We showed above (section IV.C.) how the present cap structure helps achieve objective (b)(2); it also makes ratemaking more transparent and less complex, for many of the same reasons. At the class level, the computation by which a revenue increment is calculated is clear. Objective (b)(6) also calls for reduction of administrative burden, and here too the price cap has helped. This is most clearly shown by the fact that a new set of rates can be vetted and authorized for implementation in a 45-day time frame. But, perhaps more fundamentally, the price cap's de-coupling of permissible revenue increases from the obscurities and conflicts that arise in analyzing the Postal Service's own costs allows a swift and relatively low-cost rate change process.

2. An exogenous price cap allows a simpler and more transparent ratemaking process

Objective (b)(6) focuses on process. From this perspective, a major advantage of the price cap is that the limit on each revenue increment is determined without reference to Postal Service-specific statistics. The change in the CPI-U is determined by a settled formula and is universally available, with monthly updates. (That the change in CPI-U determines only the gross revenue increment per class promotes the pricing flexibility mandated by objective (b)(4).)



By definition, a cost-of-service ratemaking regime depends entirely on the costs of the regulated enterprise.<sup>30</sup> These must be reported, in adequate and relevant detail, analyzed with respect to causation in any system which – like postal regulation under both the 1970 Act and PAEA – aims at efficient prices, and in many cases will be disputed by interested parties, who must be given a reasonable opportunity to do so.

A good example of the difference comes from Docket R97-1, decided under the cost-of-service model of the 1970 Act. It concerns the Postal Service's proposal – which the Commission rejected – to abandon the established near-100-percent volume variability for Cost Segment 3 mail processing costs, and substitute an econometrically-based analysis yielding a variability of about 76 percent.

The Commission's explanation of its decision occupied 20 pages of its Opinion and Recommended Decision and a 45-page Appendix.<sup>31</sup> Five witnesses addressed the issue. Nor was this the end of the matter. In the Commission's next Opinion, in Docket R2000-1, we find:

[3002] The Postal Service also proposes to estimate the volume variability of mail processing labor costs with an econometric model similar to the one presented in Docket No. R97-1. The model presented in this docket yields even lower variabilities for the analyzed MODS pools. As in Docket No. R97-1, the Commission concludes that these results are unreliable. The results are summarized in Section 2. The Commission adheres to the established finding that most mail processing labor costs change in proportion to volume.

The present system removes problems of this kind from the rate-setting process; they are resolved in separate “analytical principles” rulemakings under sec. 3652(a). Once resolved in this way, they remain operative unless revised –

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<sup>30</sup> This is particularly significant in the Postal Service's case. In some regulatory areas, the regulator may prescribe a uniform system of accounts for the entire class of regulated firms; this system is likely to reflect separations and levels of detail useful to the regulator as well as to the firm. No such opportunity exists in our case, since the Postal Service constitutes a single-member “class.”

<sup>31</sup> PRC Op. R97-1, ¶¶ 3001 et seq., and Appendix F.

again without the time pressures of a rate adjustment proceeding – in a further rulemaking. The result is both increased transparency and reduction of administrative burden (since relitigation of analytical issues is largely eliminated).

K. Objective (b)(6): To reduce the administrative burden and increase the transparency of the ratemaking process: workshare discounts

The transparency of ratemaking under PAEA benefits from the existence of a single, economically rational limit for workshare discounts. Inquiry into these discounts can be focused on their relationship to the cost avoided by the work-sharing. If they were not tied to avoided cost, they could be set using subjective, or at least disputable, judgments about the price sensitivity of the mail concerned, its value to the system as a whole, and the like.

L. Objective (b)(8): To establish and maintain a just and reasonable schedule of rates and classifications: the price cap

A major advantage of the price cap from the viewpoint of objective (b)(8) is that the same rule governs increases for all market-dominant classes. Under a cost-of-service regime, distribution of non-attributable costs can be largely discretionary.<sup>32</sup> Moreover, PAEA makes any detailed oversight of rates an after-the-fact process – a system clearly more consistent with objectives (b)(4) and (b)(6). It does, however, magnify the risks from misallocation of institutional costs. The damage from unbalanced assignment of those costs could be largely done before the imbalance could be analyzed and corrected. The price cap system<sup>33</sup>,

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<sup>32</sup> This can be true whether these costs are distributed by the enterprise or by the regulator. It was the case under the 1970 Act. Even in the earlier years of its administration, when the Commission was leaning more markedly toward demand pricing, relative price sensitivity was never the sole determinant of institutional cost distribution. See, e.g., PRC Op. R77-1, vol. I, pp.158 et seq., especially p. 163.

<sup>33</sup> Including the time and quantitative limits on use of unused rate authority (sec. 3622(d)(2)(C)).

however, interposes an exogenous limit on increases, thus providing a significant safeguard against that eventuality.

M. Objective (b)(8): To establish and maintain a just and reasonable schedule of rates and classifications: workshare discounts

We explained above (section IV.I., pp. 22-23) that workshare discounts greater than avoided cost would create a revenue shortfall. As long as the Postal Service needs to use substantially all available cap space, the result would be an additional demand on non-workshared mail in the same class. A discount greater than avoided cost thus leads to a tax on non-worksharing mailers to finance a revenue sacrifice for which the Service receives nothing in return. A set of rates which in effect takes money from the pockets of Single-Piece mailers for the benefit of worksharing mailers who have provided savings smaller than the discounts they receive is not a just and reasonable rate schedule.

N. Objective (b)(9): To allocate the total institutional costs of the Postal Service appropriately between market dominant and competitive products

The nature of this objective leads us to depart somewhat from our usual scheme of focusing separately on the price cap and the workshare discount limits. The issue here is what, if anything, the Commission should consider doing *within the bounds of sec. 3622*, to improve cost allocation between the market-dominant and competitive sectors.

The italicized phrase is there because most of the statutory rules for allocation of institutional costs between sectors lie outside sec. 3622, and thus outside the scope of this review, as the Commission has defined it. There are substantive rules in secs. 3631 – 3633. Analytical principles, which can govern whether a cost element is institutional, are regulated under sec. 3652.

It may be useful, however, to consider two possible interpretations of objective (b)(9). Does it mean (or mean principally) –

- That the costing techniques the Commission and the Postal Service use should adequately identify all cost elements that can be attributed, and correctly associate them with products, or
- That the rates charged for the respective products should properly reflect those attributions?

Since this review focuses on sec. 3622, the latter emphasis – for reasons just suggested – seems more likely to produce useful insights. And the evident question arising under it is whether the price cap interferes with achievement of objective (b)(9).

GCA believes that it does not. Sec. 3622(b)(9) calls for appropriate allocation of institutional costs between market-dominant and competitive products. Competitive rates are set without reference to the price cap, and whether they are lawful depends more on compliance with sec. 3631 and 3633 than on anything done under sec. 3622.

There are a few market-dominant products which fail to cover their attributable costs. This problem, however, bears no relation to objective (b)(9); it ties to the statute via sec. 3622(c)(2), the factor replicating former sec. 3622(b)(2). There is no reason to suppose that these products are underwater because costs have been over-attributed to them (or under-attributed to the competitive sector).<sup>34</sup> Review of chapter 6 of the Commission's FY2015 *Annual Compliance Determination Report*, which discusses flat-shape mail generally, shows that the problem is not that costs are misallocated, but that there are inefficiencies and informational gaps in the handling, processing, transportation, and delivery of this mail.

In short, it is difficult to see any way in which the Commission could be sure of alleviating problems of this kind by tinkering with the price cap. Attempt-

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<sup>34</sup> It is worth noting that the most far-reaching proposals for overhaul of cost attribution – those advanced by United Parcel Service in Docket RM2016-2 – would have increased attributable costs in the market-dominant sector substantially more than on the competitive side. See Docket No. RM2016-2, UPS Responses, CHIR No. 1, Questions 5 and 12(c) (December 10, 2015.)

ing to do so would simply dilute the incentive to efficiency which the cap provides, in a setting where difficulties in attaining cost efficiency are the cause of the problem.

Much the same could be said of the workshare discount limits. They are rate differentials within certain market-dominant products; hence the problems they have presented lie entirely within the market-dominant sphere.

In this section, we have discussed possible modifications to the price cap and the workshare discount rules without reference to our conclusion that the statute does not permit either to be abolished or drastically changed. It is now time to discuss that conclusion and the reasons supporting it.

## V. MAY THE COMMISSION LAWFULLY ABOLISH OR ALTER THE PRICE CAP?

### A. What does designation of the price cap as a “requirement” imply for the scope of the tenth-year review?

*Introduction.* Sec. 3622(d)(3) empowers the Commission to “make such modification or adopt such alternative system for regulating rates and classes for market-dominant products as necessary to achieve the objectives.” Sec. 3622(d), on the other hand, designates everything it enacts (including both the price cap and the present review) as “REQUIREMENTS.” Throughout sec. 3622, the system is referred to in the same language: “system for regulating rates and classes for market-dominant products.” That language (qualified by the adjective “modern”<sup>35</sup>) is used in sec. 3622(a), which is the basis for the Commission’s creation of the entire system now being re-examined.

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<sup>35</sup> This adjective seems to be immaterial to the present question. It could hardly be argued that the Commission, operating under sec. 3622(a), established *two* systems, one “modern” and one not.

When a particular phrase is used repeatedly in the same enactment, it is customary to give it the same meaning each time it appears.<sup>36</sup> Applying this canon of statutory construction to our problem suggests that if a feature of the existing system is present because sec. 3622(d) makes it a “requirement,” then it must remain in any modified or alternative system which emerges from the tenth-year review. Since the Commission was not free to omit it from the system originally established under sec. 3622(a), it may not do away with it in the tenth-year review. The price cap described in detail in subsections (d)(1) and (d)(2) clearly falls under the “requirements” rubric. Thus since it is a requirement with respect to the “system for regulating rates and classes for market-dominant products” called for by sec. 3622(a), it must likewise be a requirement for the “system for regulating rates and classes for market-dominant products” resulting from Commission action under sec. 3622(d)(3).

*The governing role of the objectives and factors.* We can begin by recognizing that *both* the initial establishment of the “system for regulating rates and classes” under subsection (a) *and* the tenth-year review are meant to effectuate (or effectuate more completely) the objectives of subsection (b), having regard to the factors listed in subsection (c). The argument starting from that fact proceeds in this way:

- a) Congress established those objectives and factors;
- b) It directed the Commission to establish a “system for regulating rates and classes for market-dominant products” which would achieve the objectives while taking account of the factors (sec. 3622(a)).
- c) It required that this system incorporate a price cap (sec. 3622(d)(1)).
- d) Therefore, Congress must have concluded in 2006 that a price cap system would – as a matter of law, one might say – achieve the objectives while taking

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<sup>36</sup> See, e.g., *Ratzlaf v. United States*, 510 U.S. 135, 143 (1994).

account of the factors, and that one lacking a price cap would not. It is significant that an earlier version of PAEA (H.R. 22) treated the price cap as a permissible provision, whereas the final enactment made it a requirement. If Congress had concluded that a price cap *could* achieve the objectives but was not the *only* mechanism which might do so, it presumably would have kept the H.R. 22 language or something like it.<sup>37</sup>

e) The Commission, in the tenth-year review, is to determine whether the existing system is achieving the objectives and accounting for the factors, and if not, to make changes or adopt alternatives so that they are achieved and accounted for. It is not given carte blanche to design a new system which ignores the original objectives or with different objectives.

f) Therefore – since Congress determined that only a price cap system could effectuate the objectives and factors – the PRC cannot abolish the price cap.

#### B. Are *any* changes feasible under the statute?

What we showed above, of course, does not dispose of all the questions concerning the price cap. Sec. 3622(d)(3) does direct the Commission, if it finds that the existing system is not adequately effectuating the objectives and factors, to modify it or adopt an alternative system. The difficulty, therefore, is roughly this: Since the same phrase is used to designate the system in sec. 3622(a) and 3622(d), a “requirement” is a requirement throughout – including the tenth-year review – *but* if every detail specified under sec. 3622(d)(1) and (2) is a “requirement,” then is the Commission limited, in the tenth-year review, to making only

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<sup>37</sup> It is also significant that some options explicitly left to the Commission in H.R. 22 were eliminated in the final enactment. In the H.R. 22 version of sec. 3622(d) – referring to “allowable” provisions – the Commission was specifically given leave to adopt cost-of-service regulation or “such other form of regulation” as it deemed appropriate to achieve the objectives consistently with the factors. Neither of these options survived in PAEA as enacted. This indicates that (i) Congress, ultimately, did *not* wish to allow a return to cost-of-service regulation, and (ii) it did not wish to have forms of regulation other than a price cap considered by the Commission.

those changes it could in any case make through rulemaking? (An example of the latter might be a change in the formula<sup>38</sup> for calculating the 12-month CPI-U average, which the statute does not specify.)

*A practical course of action.* It does not follow, in our view, that the Commission faces the dilemma of either (i) ignoring established rules of statutory construction (by treating the price cap as somehow *not* required in the system which emerges from the tenth-year review) or (ii) limiting the review to the kind of interstitial tinkering which it could probably accomplish through ordinary rulemaking, even if sec. 3622(d)(3) did not exist. A more practical course would be to identify any specific features of the (required) price cap which do not adequately effectuate the objectives and factors, point out and analyze the particular shortcomings, identify the objective(s) or factor(s) they are hindering, and find ways to correct them in detail without hindering any other objective. This procedure would count as a modification or even, possibly, an alternative system.<sup>39</sup> Since the purpose of the price cap, as originally enacted, was to achieve the objectives, taking into account the factors, and the purpose of the review is to allow the system to achieve them more completely, this course seems the most practical and effective. It also conforms to the rule that, where Congress gives an agency what seem to be conflicting instructions, the agency can satisfy the statute by devising a middle course which effectuates both sets of instructions as fully as possible.

*“Central” vs. “peripheral” features.* One principle which might be helpful is to distinguish “central” from “peripheral” features of the price cap. Although there could be disagreement about the “centrality” of some provisions, there are some fairly clear cases too. For example, sec. 3622(d)(1)(C) sets a 45-day time frame for price-capped rate changes. If the Commission concluded (i) that this limit

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<sup>38</sup> Set out at 39 CFR Part 3010, Subpart C; particularly sec. 3010.23. See Docket No. RM2007-1, Order No. 26, p. 10.

<sup>39</sup> It is not clear that there is a bright line between modification and adoption of an alternative system. But a “modification” must be something considerably less sweeping than abolition of a major element of the legislation. *MCI Telecommunications Corp. v. American Telephone & Telegraph Co.*, 512 U.S. 218, 225-228 (1994).



was too restrictive to allow it and the Service to effectuate objective (b)(6) – reduction of administrative burden and maintenance of transparency in ratemaking – and (ii) that lengthening it would not significantly interfere with achievement of any other objective, it might lengthen the schedule to 60 or 70 days. On the other hand, paragraph (d)(1)(B) calls for establishment of a schedule on which rates would change “at regular intervals by predictable amounts.” This provision is clearly responsive to, and indeed seemingly required by, objective (b)(2) (predictability and stability of rates). Its language and that of paragraph (b)(2) are essentially congruent. A key difference between the two provisions we are considering is that paragraph (d)(1)(B) directly and comprehensively *incorporates* an objective: that of predictable and stable rates. On the other hand, the 45-day limit is *one way* of administering the price cap but in itself does not directly or uniquely respond to any objective. This allows us to label it “peripheral,” whereas paragraph (d)(1)(B) is clearly “central.”

Another possibly useful heuristic principle is how far Congress specified the details of the required mechanism, or of a major element in it which can reasonably be considered on its own footing. If Congress legislated in detail on a particular topic, that fact may be an indication that it knew with substantial precision what it wanted and that, consequently, the Commission should at least be highly circumspect in considering changes. This principle, of course, would have to be employed in conjunction with the preceding one. For example, the 45-day rate case schedule, which we suggested above was “peripheral,” might also be thought of as an example of “detailed” legislation, in that Congress might instead have required merely “with all reasonable expedition,” and arguably this phrasing would have been less “detailed.” But if the Commission distinguishes between “details” which go directly to the substance of the price cap (for instance, Congress’s specification of the CPI-U as the required index) and those which do not (like the 45-day schedule) it should be possible to make the two principles work together.

*Recommendation.* For the reasons set out above, GCA recommends that the Commission retain the existing price cap, subject only to such adjustments of detail as can be shown to improve achievement of one or more objectives without interfering with the achievement of others.

## VI. THE EXISTING STATUTORY AND REGULATORY FRAMEWORK GOVERNING WORKSHARE DISCOUNTS SHOULD BE RETAINED

Much of what we say in the previous section with respect to the price cap applies to the workshare discount system as well, and GCA believes that the workshare discount limitations are similarly immune to abolition or substantial change in this proceeding. However, sec. 3622(e) does not contain the word “Requirements.” The first question, then, is whether this distinction makes a difference.

The history reviewed in section VII, below, shows that when enacting PAEA Congress essentially transformed the Commission’s long-standing practice into a set of statutory requirements. The question then is whether there is anything in sec. 3623(d)(3) empowering the Commission to change them. GCA believes that there is not.

*Is sec. 3622(e) a “requirement” – and does this matter?* An advocate arguing that the Commission can change the requirements of sec. 3622(e) might likely begin by noting that, unlike sec. 3622(d), sec. 3622(e) is not designated as a “requirement” in its running title. In GCA’s view, this is not dispositive, and not even very significant.

What is significant is not whether Congress used the word “requirement” in the running title of sec. 3622(e). It is, rather, (i) whether the basic logic of ch. 36 justifies – or indeed, requires – treating sec. 3622(e) as a requirement on all fours with the price cap and the limits on preferred rates, and (ii) whether the provision itself imposes duties on the Commission which can reasonably be viewed only as requirements. GCA believes that both questions should be answered “yes.”

*The logic of chapter 36.* The implicit logic of ch. 36, and sec. 3622 in particular, makes the existence of rates<sup>40</sup> axiomatic. There would be no point in directing the Commission to establish a modern system for regulating rates and classes if the existence of rates were not a given. Consequently, designation of the price cap as a “requirement” means that all rates are, as a matter of law, governed by the cap. There being nothing contingent about the existence of rates, and no exceptions to their being subject to the price cap, it follows that being governed by the cap is part of the definition of “rate.” In other words, that any rate we choose to examine is governed by the price cap is an analytic proposition. Its truth is guaranteed by the meaning of its terms, in the same way that the truth of “This triangle has three sides” is guaranteed by the meaning of its terms.

This is not true of workshare discounts. Their existence is not a necessary condition of there being a schedule of rates or a system of rate regulation. A system without them existed in the early 1970s, before presort discounts were initiated. They are defined (as “rate” is not) in the statute. Their existence is a contingent matter.<sup>41</sup> What the cost-avoided rule of sec. 3622(e)(2) conveys, therefore, is that *if* there is a workshare discount for a given type of mail, *then* it must not exceed the cost avoided by the worksharing, *unless* one of the defined exceptions is satisfied.

Under these circumstances, it is not hard to see why sec. 3622(e) is not called a “requirement” in its running title. Congress would not have wished to leave the impression that it was *requiring* that there be workshare discounts. First, since Congress left the definition of worksharing very largely to the Commission, doing so would have imposed a requirement of indeterminate scope. Congress, in other words, would have been laying down a rule without knowing what it would cover. Second – as the proceedings in Docket R2013-10(R) have shown – satisfactory adjustment between the Postal Service’s authority to estab-

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<sup>40</sup> In this discussion, “rates” means (all and only) “market-dominant rates.”

<sup>41</sup> As, of course, is the existence of worksharing activity itself.

lish mailing requirements and the mailers' interest in being reasonably compensated for significant work- and cost-saving activity performed in lieu of corresponding Postal Service operations is a complex problem, not soluble ex ante by a blanket legislative mandate.

*Distinguishable status and functions of PAEA provisions.* Order No. 536 contains a basic definition of the relationship between the workshare discount provisions of PAEA and its objectives and factors. The precise question before the Commission was whether certain sec. 3622(b) objectives should influence how (or whether) the specific rules of sec. 3622(e) should be applied. The Commission demonstrated why they should not.

The Commission explained that –

. . . Under the system that the Commission has established, the Postal Service enjoys a general prerogative to set market dominant rates, subject to only a few, clear “out of bounds” lines drawn by the PAEA. These “out of bounds” lines consist of pricing restrictions in three areas – the cap on class prices (see section 3622(d)), the limit on workshare discounts (see section 3622(e)), and revenue ceilings for the various categories of preferred mail (see section 3626). Congress framed each of these requirements as objective, quantitative pricing standards, made their application mandatory, and placed each in a self-contained section of the PAEA.<sup>[42]</sup>

The kind of balancing among objectives and factors which the Postal Service must do when it designs rates is subject only to ex post review (in annual compliance proceedings). Its result, therefore, is not comparable to the “objective, quantitative” determinations called for by the three mandatory standards. This is not to say that the “qualitative” provisions are less important in the overall plan of the statute; only that the agencies have more latitude in applying them than in applying the price cap, the workshare discount rules, and the preferred rate limits. (Expressed another way, the Commission’s idea was that complying with the objectives and factors involves judgmental balancing of competing principles, while sec. 3622(e)(2), like the price cap and sec. 3626, enacts a bright-line test which a rate either passes or fails.)

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<sup>42</sup> Order No. 536, p. 16.

A quite direct indication is that sec. 3622(e)(2) directs that the Commission “shall ensure that” workshare discounts do not exceed cost avoided. Although the Commission is elsewhere (sec. 3622(e)(1)) given broad rulemaking power, it has no discretion as to this rule. It is clearly a “requirement” even though that word is not used in the section title.

We are aware, of course, that this rulemaking, and the follow-on docket (RM2010-13) which established a new benchmark, took place in an entirely different context from the present system review: the benchmark rulemakings applied the PAEA system and did not inquire into potential changes in it. Does this matter?

Since Congress made sec. 3622(e) “objective” and “mandatory” there is good reason to think that Congress itself, and not the sec. 3622(d)(3) process, is the only setting in which it could be changed. The Commission’s view, expressed throughout Order 536, is that while it was given wide-ranging authority to establish a system of regulation, there were certain specifics which that system had to include if it was to comply with the statute. The distinction – also made clear in Order 536 – is between a process of balancing the often conflicting objectives and factors of sec. 3622(b), (c) in order to arrive at a “modern system” of rate regulation and the application, through interstitial rulemaking, of mandates which Congress did *not* leave to the sec. 3622(a) balancing process. Put another way: Congress *withdrew* certain aspects of the balancing process from the Commission’s system-building purview, and dictated, instead, a few features the resulting system had to have.

*The question of an “alternative system.”* The discussion so far has shown that, the absence of the word “requirement” notwithstanding, the workshare discount rules of sec. 3622(e) are no less a requirement than the price cap. As in the case of the price cap, however, the question remains whether an “alternative” system – which sec. 3622(d)(3) empowers the Commission to adopt – could dispense with them.

The wording of PAEA is important here, as it was in considering the price cap (section V, above). Section 3622(d)(3) directs the Commission, if it finds that

the existing “system for regulating rates and classes for market-dominant products” is not achieving the objectives, having regard to the factors, it may modify it or “adopt such alternative system for regulating rates and classes for market-dominant products” as may be necessary to do so. Thus subsection (d)(3) itself designates the “alternative” system in exactly the same phraseology as the existing system.<sup>43</sup> The normal rule is that identical language used twice (or more) in the same enactment should be given the same meaning each time it occurs. If this is not done in a particular case, there should be some cogent reason in the context or overall intent of the statute which compels the departure. No such reason exists in the text of PAEA, and its overall intent is best reflected in the objectives and factors of sec. 3622(b) and (c). Since, as we showed earlier, Congress concluded that the objectives and factors would be best served by maintaining the Commission’s developed view of worksharing rates, it follows that the sec. 3622(d)(3) review – governed throughout by the objectives and factors – should arrive at the same conclusion. The objectives and factors are still what they were in 2006, and since they set both the goal and the limits of what the Commission is to undertake in the sec. 3622(d)(3) review, they should still require the same treatment of workshare discounts.

Suppose, however, that a hypothetical opponent of the established methods argues along these lines: *What Congress perceived as the best way to achieve the objectives and accommodate the factors when it was legislating in 2006 might not be what it would choose today. The realization that this might turn out to be true is what led it to provide for an “alternative system” as well as allowing the Commission to “modify” the system already in place.*

A party making this argument would have to show what had changed in the ten years since enactment of PAEA, and why such changes should lead the Commission to overturn the established approach to workshare discounts. Showing the necessity for changing the system would be a difficult task, not least

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<sup>43</sup> The same phrasing is used in sec. 3622(a), directing the Commission to establish that system, except that sec. 3622(a) also describes it as a “modern” system. Omission of that adjective in sec. 3622(d)(3), as we noted earlier (p. 34, fn. 29), seems to be immaterial..

because the established system embodied in PAEA is itself highly flexible. The Commission demonstrated this in two interconnected rulemakings, Dockets RM2009-3 and RM2010-13.

*Lessons from the benchmark rulemakings.* Sec. 3622(e)(1) authorizes the Commission to “further define[ ]” worksharing by regulation. In Docket RM2009-3, the Commission, exercising this authority, concluded that the then-established bulk metered mail (BMM) benchmark for calculating workshare discounts in First Class was no longer necessarily valid.

To isolate the effects of worksharing from other cost driving effects, the analysis must focus on the costs affected by worksharing. The non-work-shared mail used for comparison (referred to as the “base group” or “benchmark”) should be as similar to the workshared mail as possible. Selecting a base group which shares market characteristics with the work-shared mail helps ensure that the decision to use either of the two categories is primarily based on the mailer’s total combined cost of preparation and postage as opposed to non-cost considerations. . . . To best isolate the Postal Service’s savings from worksharing, the base group should also share non-worksharing cost-driving characteristics, such as shape and machinability, with the workshared group. . . .

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Since Docket No. R97-1, the Commission and the Postal Service have used BMM as the based group for estimating the worksharing savings for First-Class letters. BMM consists of letters that pay single-piece rates, have metered indicia, are machinable, with printed addresses, and are entered at Postal Service facilities as full trays of faced mail. . . . Many commenters argue that BMM no longer serves as a relevant base group for setting discounts for any type of mail. . . .

In the discussion of First-Class Mail, the Commission concludes that there is still a significant market overlap between presort mail and a substantial part of single-piece mail. However, the evidence presented in this case strongly suggests that the current BMM benchmark is obsolete. For example, the assumption that significant amounts of single-piece mail are entered faced in full trays at Postal Service mail processing facilities needs to be re-examined. . . .<sup>[44]</sup>

The Commission instituted Docket RM2010-13 to determine whether the BMM benchmark should be scrapped, and if so what should replace it.

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<sup>44</sup> Order 536, pp. 62-63.

This episode illustrates how the workshare ratemaking system developed over the years, and embodied in sec. 3622(e), has the flexibility to adapt to changing circumstances in mail markets. The Commission, with due input from the Postal Service and mailer groups, has exercised this flexibility *while maintaining the basic principle of pricing workshared categories to maximize productive efficiency and achieve lowest combined cost for workshared mailings, through limiting discounts to savings actually generated by worksharing*. This fact should be kept in mind as we consider whether (leaving aside the question whether they are legally feasible) proposals to change existing workshare ratemaking principles are necessary.

Consequently, GCA believes that neither the general mandate of sec. 3622(d)(3) nor its reference to a possible “alternative system” empowers the Commission to abolish or drastically change the workshare discount rules established by sec. 3622(e). If this view were not accepted, however, we would need to show that, given the objectives and factors which govern the tenth-year review, they *should not* be changed or done away with. In section IV above, we showed how the present workshare discount system promotes the relevant objectives and factors. In the following section, we summarize the history of that system, to show that it has followed a consistent, rational course of development.

## VII. THE HISTORY OF WORKSHARE DISCOUNTS DEMONSTRATES WHY THE EXISTING SYSTEM SHOULD BE RETAINED

### A. Introduction; historical review

The system for regulating rates and classifications for market-dominant products, established under sec. 3622(a), incorporates a long and successful history of pricing to improve the productive efficiency of the bulk mailstream. Various attempts to depart from the approach so developed have led the Commission to analyze it and the reasons underlying it; as a result, we already enjoy the



benefits of more than one retrospective examination. In each case, the Commission has refined our (and its own) understanding of why, and how, workshared mail is priced differently from single-piece, and – particularly within purely bulk-entered classes – differently for different shapes and descriptions of mail.

The re-examination mandated by sec. 3622(d)(3) cannot ignore this history and the explanations the Commission has given. In this discussion, we will (i) focus on First-Class Mail, and (ii) refer to the relevant categories by their current names – “Single-Piece” and “Presort” – although these titles were not always used in the early decisions.

*The beginnings of workshare discounts.* The essential concept of workshare discounts goes back to the beginning of rate regulation under the 1970 Postal Reorganization Act<sup>45</sup>, but the decision in Docket No. R77-1 contained the first discussion which is both detailed and relevant to present concerns. In that case, worksharing First-Class mailers argued that Presort should be deemed a subclass, with its attributable cost built up from costs specifically associated with it (which the Postal Service would be able to ascertain in its Revenue and Cost Analysis system, then undergoing an overhaul) and its own cost coverage separately based on all the sec. 3622(b) pricing factors.<sup>46</sup>

The Commission concluded that Presort was not a subclass but a rate category. This determination had two consequences, one of which is particularly relevant here. The first substantial argument the Commission addressed was that since the Service had decided to track Presort costs separately, subclass treatment was in order. The Commission observed (PRC Op. R77-1, pp. 244-245) –

Nor do we find that the Postal Service’s agreement to include presorted first-class mail in its ongoing cost data systems necessarily implies that a separate subclass was intended. Those data systems are designed to develop separate attributable costs for the included mail categories. It is undeniable that including presorted first-class in this system will make it possible to analyze its attributable costs separately. It is equally clear that it

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<sup>45</sup> It arose as an issue in the first general rate case (Docket R71-1) and the classification came into being in the scope-and-extent case, Docket MC73-1.

<sup>46</sup> See PRC Op. R77-1, pp. 240 et seq.

will make it possible to measure the cost avoidance of presorted relative to regular first-class mail, since that information is readily derived from the same data. Therefore, in our view, this data collection requirement does not imply any particular classification status for presorted first-class mail.

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1/ Indeed, because they are already in place, use of these continuing data systems may be a better means of obtaining current, accurate measurements of cost avoidance than using sporadic, ad hoc studies of avoidable costs.

The footnote just quoted does not mean that in 1978 the Commission believed that the full *cost* difference reflected in the RCA system would necessarily be the measure of the *rate* difference(s) between Presort and Single-Piece. The issue was not how to scale Presort rates but whether regularly updated RCA costs would be a sounder basis for estimating *cost avoidance* than occasional engineering studies which might (or might not) be adequately updated as cost levels and mail characteristics changed over the years.

The Commission – after noting that the classification status of a mail category “can be properly evaluated only in terms of a specific legal purpose”<sup>47</sup> – reviewed the early history of the Presort concept and stated that –

Upon reviewing the purpose for which this presort discount was established and the factors relied upon to support that decision, we conclude that this mail category was primarily intended to bring about a structural reform within first-class mail in order to align rates with costs rather than to give recognition to unique characteristics of presorted first-class mail which would warrant an independent application of all the §3622(b) rate-making criteria to this category.

In MC73-1 we found that the purpose of the presort discount was to provide to the mailer who presorts equitable compensation for the costs avoided by the Service, to encourage such worksharing, and, as a consequence, improve service. . . .<sup>[48]</sup>

Clearly, thinking on the subject of Presort was still in an early stage; the Commission did not distinguish between workshare-related and “intrinsic” cost-

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<sup>47</sup> Id., p. 246.

<sup>48</sup> Id., p. 247; fn. omitted.

saving characteristics, as it has had to do since – in preliminary fashion in the next rate case, and more recently as well (most notably, perhaps, in Docket No. RM2009-3). Nonetheless, it is evident that from the beginning the Commission was clear about the rate category/subclass distinction, the reasons for it, and why Presort had to fall on the rate category side.

Presort issues arose again in Docket R80-1. For the first time, however, the RCA system provided cost data for Presort; Presort mailers again argued for subclass status, without success. The Commission narrowed the determining issues down to two: cost difference and distinctness of market served. The Commission recognized the cost difference, and with respect to the alleged difference in market observed that –

[0688] With respect to market demand, the evidentiary record is meager and the alleged difference between the two mail groups is conclusory. . . .

[0689] All of these factors<sup>[49]</sup> would be reflected in the elasticity of demand for these respective mail groups. Substantially different elasticity coefficients for these respective groups would constitute a prima facie showing that the requisite demand differences exist. Separate elasticity coefficients have not, however, been estimated on this record, nor have market studies been provided from which substantial differences in demand curves might reliably be inferred. Absent objective or quantitative evidence, the evidence we must rely on is subjective and descriptive. Such evidence must, therefore, clearly point in the direction of substantial demand differences, before we may recognize presorted first-class as an independent subclass.

The Commission went on to demonstrate that the required showings had not been made. Its decision to continue treating Presort as a rate category was upheld in *Newsweek, Inc. v. U.S. Postal Service*, 663 F.2d 1186, 1209-1210 (2d Cir., 1981).

*Finding a method.* As noted, Docket R80-1 featured reasonably comprehensive comparative cost data for Presort and Single-Piece. The Postal Service,

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<sup>49</sup> In the preceding paragraph the Commission had listed several factors likely to influence demand for a product.

however, pointed out that this difference (\$0.071/piece) “grossly overstate[d] the costs actually avoided when nonpresorted is converted to presorted mail.”<sup>50</sup> It argued that in view of the uncertainty as to where the true avoided cost fell in the (large) range between the RCA total cost difference and the \$0.02837 difference resulting from updating the original MC73-1 estimate, a “conservative” approach, implying a discount of \$0.03, would be best.

The Commission decided to adapt to First Class the method already used by the Service for second- and third-class mail: modeling the costs (direct and indirect) of individual processing operations known from field observations to be avoided by presorting, and subtracting the resulting cost figures from the RCA cost of non-presorted mail.<sup>51</sup>

As might have been expected, given the Second Circuit’s decision, the rate category/subclass issue, though it re-surfaced in Docket R84-1, produced little new analysis. Measurement of avoided cost was controversial, however, in part because the Postal Service proposed a new method: rather than identifying processing operations avoidable by presortation, costing them out, and subtracting the results from the cost of a non-presorted letter, the Service’s witness estimated the *additional* cost which would be incurred if a Presort piece “reverted” to Single-Piece. The Commission found this approach too conservative, particularly in light of its recognition that the rapid growth of Presort was not entirely at the expense of Single-Piece volume, and treated it as an “absolute floor” for avoided cost. Its own solution was the “Appendix F” method:

[5141] As an estimate of the relevant cost differences which does not suffer from the deficiencies just described, we have taken the RCA report and isolated the unit difference in mail processing cost between presort and single-piece First Class. The calculations can be found in Appendix F to this decision. The method shown gives a rough approximation of the difference which can be expected in the test year. The record does not

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<sup>50</sup> PRC Op. R80-1, ¶0696 (fn. omitted).

<sup>51</sup> Some Presort parties used similar modeling techniques, but began with the total RCA processing cost of letters, rather than limiting their analysis to operations identifiably avoidable by presortation. By doing so, they included non-presort-related cost effects in the arithmetic. For this reason, the Commission rejected that style of analysis. PRC Op. R80-1, ¶¶0699 et seq.

contain sufficient information to develop a more precise estimate. The difference is 4.9¢. We recognize that part of this differential is caused by factors other than presort. This figure corresponds to the one identified by witness Bentley, but does not include analysis of the operations, unconnected with sortation and hence inappropriate in arriving at a presort differential, which witness Bentley used to reach 5.65 cents. On this record, we find that the most appropriate discount for five-digit presort is 4¢.

For present purposes, Docket R90-1 is the next helpful decision. The Commission explained the distinction between “cost difference” (in what might be called its “pure state”) and “cost avoidance.”

[5067] Because the benchmark cost (the higher cost being compared to the automated or presorted piece) under the cost difference methodology is all nonpresorted mail, the cost difference methodology produces a cost variation due to factors unrelated to mailer presortation efforts. Presort mail tends to be “cleaner.” In comparison to the nonpresort benchmark, presort mail is generally printed (or typewritten), and more uniform than nonpresort mail. These factors, and possibly others, which are unrelated to mailer presortation may contribute to the magnitude of the cost difference between presorted and nonpresorted mail.

[5068] In contrast, the cost avoidance methodology excludes these factors because it relies on an “identical piece” as the basis for comparison. The cost calculation compares the cost of a piece of mail without the work-sharing characteristic with a piece identical in every respect except that it contains the worksharing characteristic; for example, it is presorted to 3/5 digits. In theory, the resulting cost differential is limited to savings due to mailer presorting. . . .

The Postal Service’s expectation that automation would come to dominate letter processing and thereby reduce the value of presortation was a strong influence in Docket R90-1. Its witness calculated that the Appendix F method implied a cost difference between Presort and Single-Piece of \$0.05, whereas the actual savings (by the cost avoidance method) were only \$0.018. This dichotomy was of particular significance, however, for the proposed *automation* discount.

. . . [Postal Service witness] Lyons argues that retention of the Docket No. R87-1 presort methodology gives mailers the wrong signal because it implies that the value of presortation is relatively unaffected by automation when in fact this is not the case. Recognizing that the Commission may be unwilling to depart from cost avoidance principles in calculating the presort discount, Lyons proposes that this bias be moderated by changing the

benchmark figure for nonpresort automation discounts to nonautomated meter mail.<sup>52]</sup>

The Service's position was, in essence, that meter mail would be easy to convert to automation-ready status, whereas the general run of nonpresort letters – including, as Mr. Lyons put it, “Christmas cards and other ‘dirty’ mail” – would not, and would imply too large a savings estimate. The Postal Service's proposed benchmark, therefore, focused closely, for the first time, on the operational realities of likely conversion to automation-ready letter formats.

Consequently, *presort* discounts were now to be set by a qualified cost *difference* method (the Appendix F technique), while *automation* discounts would be generated by a cost *avoidance* approach focused on an attempt to identify savings likely to be achieved under real-world conditions.<sup>53</sup> As automation became more dominant in the First-Class bulk letter market, the usefulness of the cost difference method declined correspondingly, and the Commission acknowledged as much in Docket MC95-1.<sup>54</sup>

*The Mail Classification Reform I decision.* The Commission could have been forgiven, at this point, for thinking that the subclass/rate category issue was dormant, or perhaps dead. It was not.

Docket MC95-1 brought a very significant re-examination of workshare discount practice, particularly in First Class. The Postal Service proposed to divide First Class into discrete subclasses, “Automation” and “Retail.” According these groupings subclass status would have required them to pass both the “cost difference” and “distinct market” tests – which the Commission found they had not done. While it recommended rates not very different from those the Service had proposed, it retained the existing rate-category organization of First-Class Letters.

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<sup>52</sup> PRC Op. R90-1, ¶ 5094.

<sup>53</sup> See PRC Op. R94-1, ¶5039.

<sup>54</sup> PRC Op. MC95-1, ¶4293, fn. 41.

In so deciding, the Commission was not mechanically following a rule. There was (as there still is) a sound economic rationale for its approach, and the Commission explained it fully. It pointed to the connection between the Service's two-subclass proposal and its advocacy of basing rates on all cost differences between them, rather than just those related to the worksharing activity. Where two products ("rate categories," in 1990s terminology) share a market – that is, where they are generally used by (many of) the same mailers for like purposes – we expect the choice between them to be made on the basis of comparative cost.<sup>55</sup> Once it is established that the motive for the choice between products is cost, it follows that pricing can be so managed as to maximize overall efficiency.

The Commission explained this reasoning at ¶¶4211-4212 of the MC95-1 Opinion:

. . . [E]xcept for the Enhanced Carrier Route subclass, the Postal Service's proposed new subclasses do not define distinct markets for distinct delivery services. Rather, they define like markets for like services that can be provided by the Postal Service at different costs, depending on the degree of worksharing that the mailer performs. Because specific worksharing operations define the proposed automation subclasses, the relative costs of those worksharing operations are the essential distinction between them and the residual categories. Put in economic terms, it is the Commission's view that within current subclasses, the cross-elasticities between the proposed automation subclasses and residual categories, though unmeasured, are likely to be high.

[4212] The Commission finds that for rate categories within a given subclass, combined cost (the mailer's internal costs plus the Postal Service's costs) is the appropriate focus for rate design. It finds that the mailer's purchasing decisions are based on his internal costs, plus postage, while any perceived differences in the delivery service provided do not play a significant role. Under these circumstances, the most meaningful market signal sent by the price of the rate categories, including proposed automation subclasses, is one that accurately indicates their cost relative to other workshare categories through which essentially the same delivery service can be obtained. Therefore, the automation subclasses proposed by the Postal Service should remain worksharing categories within existing subclasses. Accordingly, it is appropriate to calculate the rate for these and other workshare categories as discounts from a basic

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<sup>55</sup> Including the mailer's internal cost to comply with any requirements attached to one product, as well as its postage cost. If, on the other hand, service differences were the motivator, we might conclude that the mailers were using the two products for *different* purposes.

subclass rate. This record has reconfirmed the Commission's long-held view that workshare discounts should reflect the costs that the Postal Service avoids by worksharing, so that the category makes the same per-piece contribution to institutional costs that it would have made had it not undergone worksharing.

The Commission was not here writing on a clean slate. Indeed, it observed that, in effect, it had been doing efficient component pricing from the outset.<sup>56</sup> The principles underpinning this conclusion have not changed, either through the Commission's re-thinking them or – significantly for present purposes – because Congress subsequently legislated on the subject of workshare discounts. The next major review came when the Commission found it necessary to re-examine the benchmark it had used for computing discounts.

*Adjusting the benchmark.* In Docket No. RM2009-3, the notion of an effectively complete separation of Single-Piece and Presort First-Class Letters re-surfaced – though the idea of separate subclasses did not. The Postal Service, along with some Presort users, argued for a rate-setting process which recognized all the cost differences between the two products, and not just those associated with actual worksharing.

This approach rested partly on a legal theory advanced by the Postal Service, which the Commission rejected.<sup>57</sup> But the Commission also explained the substantive reasons for the established methods.

Basic to this explanation was the Efficient Component Pricing (ECP) principle. The principle itself, understandably, was treated as both familiar and con-

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<sup>56</sup> PRC Op. MC95-1, ¶3074 (*italics added*):

. . . From the inception of worksharing discounts, the Commission has been concerned with both equity and economic efficiency. It set the first such discount at clearly capturable avoided costs. This provided a rate incentive to mailers which would allow cost-based decisions on whether to engage in the worksharing activity. *In effect, the Commission was setting discounts in conformity with what later became known as efficient component pricing.* . . .

<sup>57</sup> Order No. 536, pp. 23 et seq. The theory, briefly, was that because of the wording of a data-reporting provision, there could not be a worksharing relationship between two different *products* – which Presort and Single-Piece were, in the current mail classification schedule.



trolling; the concrete problem before the Commission was how to apply it – specifically, what reference group of mail would provide an accurate estimate of avoided cost. The Commission made this determination hinge on price:

. . . The factual question to be answered is whether a group of mailers is indifferent to using a full-service version of a postal service or an unbundled version of that service, except for the prices charged for each. If the group is indifferent about this decision except for price, it indicates that a workshare relationship exists between the full-service category and the unbundled category. This would make the discount subject to the limit mandated by section 3622(e).<sup>[58]</sup>

Docket RM2009-3 did lead to a change in the benchmark, since the Commission concluded that the bulk metered mail (BMM) benchmark was no longer appropriate.<sup>59</sup> This was so, the Commission said, because it was “no longer likely to be representative of the portion of single-piece mail that is likely to become work-shared given [an] appropriate price incentive.”<sup>60</sup> Thus the Commission adapted the same principles that had long governed discounts to changes in the characteristics of the relevant mail. And in the follow-on docket, it adopted the benchmark – metered letters – which is still in use.

## B. Conclusions from the historical review

What emerges most clearly from this history is that the Commission has followed an essentially steady course in developing worksharing rates since it first considered their theoretical underpinnings in Docket R77-1. While there have been shifts in the way basic ideas have been applied (for example, in introducing the Appendix F method for presorted letters, and then retreating from it as automation became more dominant, and in adjusting the benchmark to changing conditions in the letter mail market), the focus has always been on (i) how work-sharing – appropriately analyzed and described – affects the *Postal Service's*

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<sup>58</sup> Order No. 536, pp. 38-39.

<sup>59</sup> Proposed by the Service and adopted by the Commission in Docket No. R97-1.

<sup>60</sup> Order No. 536, p. 40. The Commission simultaneously started Docket RM2010-13 to investigate what the new benchmark should be. The results were enunciated in Order No. 1320.

cost to handle a letter, and (ii) the fact that worksharing rates are incentives for mailers to change their methods in useful ways, and not merely a passive reflection of differences in recorded costs. These two persistent themes have led naturally, as they still do, to the conclusion that the best general principle for constructing worksharing rates is Efficient Component Pricing. As the Commission explained in Order 536 (and elsewhere), this rule operates through price to generate improvements in productive efficiency. Hence it does not require, or even allow for, application of the pricing standards of PAEA, any more than it did when the process was governed by the 1970 Act. The function of a workshare discount is to inform a mailer whether – given its own cost structure – performing a specific worksharing operation is or is not remunerative for it.

This history was well and widely known among those who follow postal affairs – including, significantly, the 109th Congress. Since the workshare provisions of the Postal Accountability and Enhancement Act of 2006 (PAEA) are fully compatible with the Commission’s consistent development of workshare pricing, it is futile to argue that PAEA somehow requires that history to be disregarded. In this connection, it is important that PAEA *starts* with a recital of objectives to be attained and factors to be considered in establishing a modern system of regulation, and *in the same chapter* enacts a set of rules reflecting the Commission’s development of workshare discount theory and practice. The obvious inference is that Congress believed those objectives and factors would be best served by preserving the Commission’s treatment of worksharing.

## VIII. SUMMARY AND RECOMMENDATIONS

For the reasons stated above, GCA recommends that the Commission retain in their present form both the price cap required by sec. 3622(d) and the rules for workshare discounts set out in sec. 3622(e). We believe that both sets of provisions are in fact outside the scope of this sec. 3622(d)(3) review, but even if this legal conclusion were not accepted, both should be kept in place on their merits. There may be points of detail as to which improvements could be made

without disturbing their essential structure, and in our discussion of the price cap (section V, above) we have suggested some principles for deciding whether and how this might be done. Our principal message, however, is that both the price cap and the workshare discount limits have succeeded in furthering the objectives of sec. 3622(b).

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Respectfully submitted,

GREETING CARD ASSOCIATION

David F. Stover  
2970 S. Columbus St., No. 1B  
Arlington, VA 2220-1450  
(703) 998-2568  
(703) 998-2987 fax  
E-mail: [postamp02@gmail.com](mailto:postamp02@gmail.com)

## APPENDICES

INITIAL COMMENTS OF THE GREETING CARD ASSOCIATION  
Postal Regulatory Commission Docket No. RM2017-3

Postal Regulatory Commission Docket No. RM2017-3

## INITIAL COMMENTS OF THE GREETING CARD ASSOCIATION – APPENDIX A The Price Cap in Relation to Postal Service Deficits

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This paper analyzes the following question: Does the price cap cause the USPS operating deficits?

The answer is no. The price cap system did not cause USPS deficits. In fact, without the retirement pre-funding expenses, the USPS had operating surpluses in 2013-15. The USPS operating deficits during the past three years were solely due to retirement prefunding expenses. In order to balance the budget, the USPS would have to raise their prices by between 18.8% or 26.3% to cover the annual retirement prefunding expenses.

## ***Question: What are the financial impacts of the price cap on USPS deficits?***

The financial position of the U.S. Postal Service (USPS) has been a major concern for over a decade. The USPS identifies four major areas that contribute to its current financial position: volume decline, the universal service obligation, price, and labor costs.<sup>61</sup> Of these, the USPS has little ability to control volume decline, it has gained efficiencies in operations and reduced controllable labor costs, and has benefited from the exigent surcharge which increased the price its market dominant products higher than what was allowed under the price cap regulation. Despite these efforts, the USPS has significant non-controllable costs which are largely comprised of government benefit funding requirements.

It is essential that the USPS address its financial issues. However, the USPS financial deficits cannot reasonably be resolved by removing the price cap and recovering losses from increase in postage. Instead, the USPS needs to engage in a real reform to address its long-term issues of declining mail volumes and increasing non-controllable costs. Research shows that the most serious postal financial issues do not directly result from the price cap regulation, but instead likely require substantive legislative policy decisions on the structure and operations of the USPS.<sup>62</sup> This paper provides further support for this position.

### **Prefunding Retiree Health Benefits Requirements Drive the USPS Deficits**

The USPS is an independent government agency. As a result, it is subject to federal compliance requirements such as maintaining a government pension system that private companies are not required to uphold. The Retiree Health Benefits (RHB) obligations are mandated by the federal government and out of the control of the USPS. Time and time again, the RHB prefunding obligation specifically has been identified as the primary cause of the USPS deficits. According to the Office of the Inspector General: “[from] 2006 to 2015, the Postal Service handled 1.8 trillion pieces of mail. The Postal Service would have broken even with 3.1 cents in cost savings, or additional revenue or a combination of both. Of the 3.1 cents in Postal Service losses, 2.8 cents is due to Retiree Health Benefits.”<sup>63</sup> Furthermore, without this obligation, the USPS would recover 90% of its losses.

The lack of flexibility to adjust benefits programs or payments has been detrimental to the USPS who has found itself deep in debt despite achievements in reducing labor and operations costs, and increasing efficiencies. Excluding RHB funding obligations, the USPS has reduced its total costs by \$13.7 billion since 2006 after adjusting for inflation; \$10.2 billion of which were reductions in labor expenditures.<sup>64</sup> In fact, in most recent three years (2013-15), the USPS operations excluding prefunding requirements have been positive (Table 3.1).

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<sup>61</sup> United States Postal Service. 2012. Plan to Profitability, 5 Year Business Plan. February 16.

<sup>62</sup> Ravnitzky, Michael J. 2014 “Postal Price Cap Regulation: US Experience Since 2006.” Presented at the Rutgers Univ. Center for Research in Regulatory Industries Eastern Conference, Shawnee on Delaware, Pennsylvania, May 14-16

<sup>63</sup> USPS Office of the Inspector General. 2016. Peeling the Onion: the Real Cost of Mail. RARC Report RARC-WP-16-009. April 18.

<sup>64</sup> USPS Office of the Inspector General. 2016. “Peeling the Onion: the Real Cost of Mail.” RARC Report RARC-WP-16-009. April 18.

**Table A.1**  
**USPS Operating Balance With and Without Prefunding Benefit Expenses, 2011-2015<sup>65</sup>**

(in millions)	2011	2012	2013	2014	2015
<b>Total Revenue</b>	<b>65,711</b>	<b>65,223</b>	<b>67,318</b>	<b>67,830</b>	<b>68,928</b>
<b>Total Operating Expenditures</b>	<b>70,634</b>	<b>80,964</b>	<b>72,128</b>	<b>73,178</b>	<b>73,826</b>
Compensation and benefits	48,310	47,689	46,708	46,000	47,519
Workers' compensation	3,672	3,729	1,061	2,554	1,760
Other operating expenses	16,211	15,817	15,909	15,939	15,736
Retiree health benefits*	2,441	13,729	8,450	8,685	8,811
PSRHBF prefunding expense	--	11,100	5,600	5,700	5,700
<b>Operating Balance (+/-)</b>	<b>-4,923</b>	<b>-15,741</b>	<b>-4,810</b>	<b>-5,348</b>	<b>-4,898</b>
Excluding prefunding benefits (+/-)	-4,923	-4,641	790	352	802

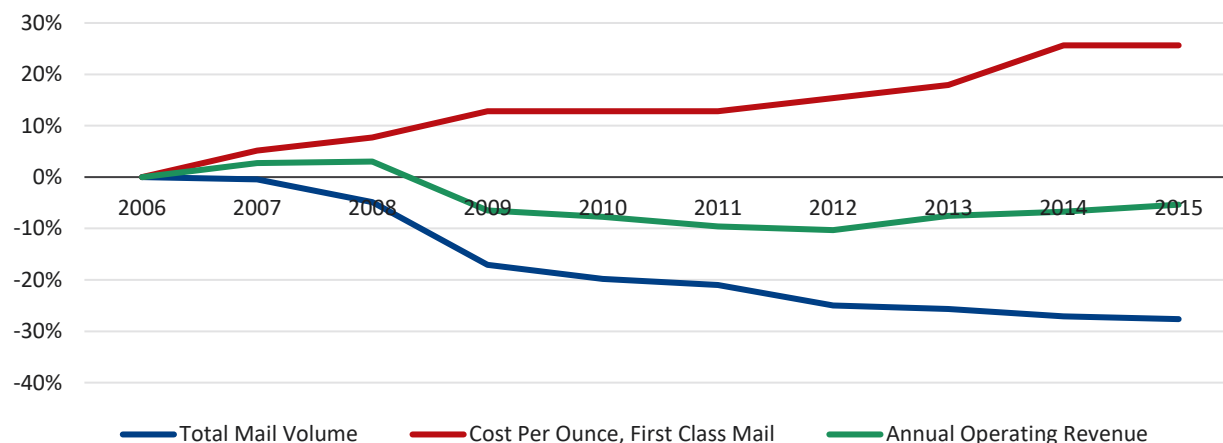
\*With the passage of the PAEA, the \$5.5 billion scheduled PSRHBF prefunding payment originally due in 2011 was delayed until 2012. As a result, PSRHBF expenses were zero in 2011. PSRHBF expenses in 2012 totaled \$11.1 billion which included \$5.5 billion for the postponed 2011 amount and \$5.6 billion for the scheduled 2012 amount.

## Eliminating the Price Cap Will Not Resolve the Financial Deficits of the USPS

Eliminating the price cap will not solve the financial deficits of the USPS. Historically, the volume decline has been too great to make up the losses. In the last 10 years, the USPS has not been able to generate the same amount of revenue as it did in 2006, even with significant increases in price. In fact, the price per ounce for First-Class Mail increased 26% between 2006 and 2015, while revenue dropped 5% (Figure 3.1).

<sup>65</sup> United States Postal Service. 2015. Form 10-K FY 2015.

**Figure A.1**  
**Change in Total Mail Volume, Price per Ounce, and Total Revenue, 2006-2015<sup>66</sup>**



Even if the price cap were lifted, the USPS would need an extraordinary increase in postage prices to cover its losses from the RHB obligations. From 2011 to 2015 the USPS spent \$28.1 billion on RHB prefunding, an average of \$5.62 billion per year.<sup>67</sup> To examine the required increase in revenue per piece to cover the retirement prefunding expenditure, we use FY 2015 revenue and volume statistics and the latest USPS elasticity estimates (which are on the lower bounds) to analyze the impact on revenue generation and volume decline.<sup>68</sup> We estimated that the USPS would need to raise their prices by an additional 18.8% by piece of First-Class Mail, Standard Mail, and Periodicals or an additional 26.3% by piece of First-Class mail. In comparison, the price increase under the price cap for market dominant mail that is based on the Consumer Price Index, is 1.7%. Note that because the USPS demand elasticity estimate for First-Class mail is relatively inelastic, the decline in volume due to the price increase for First-Class Mail only would be 5.3%, compared to 6.8% for the combination of First-Class, Standard Mail, and Periodicals (Table 3.2).

<sup>66</sup> United States Postal Service. 2016. A Decade of Facts and Figures. <https://about.usps.com/who-we-are/postal-facts/decade-of-facts-and-figures.htm>

<sup>67</sup> USPS. 2015. Form 10K FY 2015.

<sup>68</sup> USPS. 2016. "Narrative Explanation of Econometric Demand Equations for Market Dominant Products." Filed with Postal Regulatory Commission. January 20; USPS. 2015. Cost & Revenue Analysis FY 2015.



**Table A.2**  
**Estimated Increase in Revenue per Piece to Cover Retirement Prefunding Expenses**

	Increase in revenue per piece	Decline in volume due to increase
<b>Scenario: Cover Average Annual Prefunding Requirement (\$5.6B)</b>		
First-Class, Standard and Periodicals	18.8%	6.8%
First-Class Only	26.3%	5.3%

Price increases of this magnitude have never been implemented by the USPS. The exigent surcharge adopted beginning in January 2014 to regain losses from the Great Recession was 4.3% (including CPI adjustments the price of a First-Class stamp increased by 6.5%) and the annual decline in First-Class Mail volume from 2013 to 2014 was 3.3% for First-Class Mail. Therefore, it is reasonable to anticipate that an increase of over 26.3% in First-Class rates will likely decrease the volume of First-Class Mail more than the expected 5.3% calculated using USPS elasticity estimates. Notably, while the USPS demand elasticities are reported to be relatively inelastic, studies have shown that the USPS model may underestimate elasticity. For example, a study by Margaret Cigno et al found that own-price elasticity of First-Class mail could be 0.85 compared to the USPS estimate of 0.25.<sup>69</sup> In other words, the USPS model would be interpreted as a 1.0% increase in price would result in a 0.25% decrease in volume; the Cigno model would predict a 0.85% decrease in volume for every 1.0% increase in price. This is a significant difference which would have a detrimental impact on mail volume if the price is increased too great.

A steep price increase will only exacerbate the decline in volume, and may result in a loss of revenue. Even without price increases, the mail volume has been declining. Without any change in price from 2014 to 2015, First-Class Mail declined 1.9%, and First-Class Single Piece Mail, specifically, declined 4.2%. Unlike other markets, once a consumer decides to leave the market, they are unlikely to return, even if price decreases again. The USPS identifies the following characteristics associated with mail volume declines that will continue to hinder the USPS's ability to generate increased revenue from its market dominant product. According to the USPS<sup>70</sup>:

- The decline in volume of First-Class Mail is largely due to electronic diversion.
- The decline in volume reflects a permanent shift in behavior.
- The mail mix is evolving and producing lower per-piece revenue.
- The market of consumers is evolving, and is less likely to communicate via mail.

<sup>69</sup> Cigno, Margaret M., Elena S. Patel, and Edward S. Pearsall. 2014. "Estimates of U.S. Postal Price Elasticities of Demand Derived from a Random-Coefficients Discrete-Choice Normal Model."

<sup>70</sup> United States Postal Service. 2012. Plan to Profitability, 5 Year Business Plan. February 16.

As a result, the USPS cannot rely on increased prices to solve its debt crisis. In fact, increasing the price of postage of cover the debit would likely reduce volume dramatically. Removing the price cap to increase revenue from mail, has potential to generate additional revenue in the short run, but the added volume decline due to the price increase could negatively impact USPS's long run revenue from mail.

## **A Long Run Solution Is Required For a Long Run Problem**

The USPS recognizes that structural change is required to create meaningful change in the long run financial viability. Trying to generate additional revenue from the declining sector is potential short term fix for a long run issue. In order to be truly financially stable, the USPS must push for changes in its benefit structure and more importantly must innovate and maximize growth in sectors with increased demand. While First-Class mail is the foundation of the postal service, the Postal Service reported \$3.4 billion in revenue from new products and innovations over the last 3 years and estimates continued efforts could contribute up to \$10 billion when fully implemented.<sup>71</sup> If the USPS could advance its innovation efforts, it could more quickly explore and implement creative solutions to improve the financial health and long term vitality of the postal service.

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<sup>71</sup> USPS Office of the Inspector General. 2016. "U.S. Postal Service Pilot Programs." Report Number MS-AR-16-005. August 16.

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Postal Regulatory Commission Docket No. RM2017-3

## INITIAL COMMENTS OF THE GREETING CARD ASSOCIATION – APPENDIX B

### The Price Cap in Relation to Quality of Service

This paper analyzes the following question: Does the price cap negatively impact the quality of service for consumers?

The answer is no. Theoretical and empirical economic studies show that the price cap system for natural monopolies such as the USPS does not have a negative impact on the quality of service for consumers. However, it should be noted that the USPS has experienced issues with service quality, especially as it relates to 3 to 5 day delivery in rural areas; these issues are identified to be a result of decisions made on network realignment and not the price cap.

## ***Question: Does the price cap negatively impact the quality of service for consumers?***

Since the end of the 19<sup>th</sup> century, U.S. Postal Service (USPS) has been required to uphold a universal service obligation, offering free home delivery to both urban and rural areas in the United States. As such, Americans have access to the postal delivery services regardless of geographic location. Because of the extensive network that must be maintained to meet this obligation, the U.S. Postal Service was granted a monopoly status for First-Class letters. The USPS also handles other non-competitive products (i.e., market dominant) such as Standard Mail and Periodicals because of its market power as defined in 39 USC sec. 3642(b).

As often seen with natural monopolies (industries with high infrastructural costs and barriers to entry such as public utilities including the USPS), governments implement regulations to protect consumers from abusive market power and excessive pricing. While there are a variety of regulatory pricing models that can be used to meet this objective, incentive regulation such as the price cap regulation (PCR) has become a common practice, largely because of its ability to achieve desired outcomes for consumers while maintaining some profit incentives for the monopoly through cost reduction<sup>72</sup>. The PCR is successful in increasing network efficiency, maintaining some flexibility, and controlling prices that may otherwise be burdensome to consumers for goods and services produced by a natural monopoly such as common mail delivery.

While regulators seek to protect consumers from abusive and excessive prices, consumers also value the quality of service. Therefore, regulators also consider the quality of service when regulating price. In this paper we review current academic literature to assess the impact of the price cap regulation on the quality of service.

## **The Price Cap Regulation Does Not Reduce Quality of Services for Consumers**

Consumers value both low prices and high quality of services. In order to maximize the benefit to consumers, there must be a balance between the two. Consumers would not be satisfied with the combination of low prices and poor quality of services. Alternatively, consumers only have a limited tolerance for higher prices and higher quality of services.

It is well established that consumers benefit from lower prices for goods and services produced by natural monopolies under the PCR.<sup>73</sup> However, there is ongoing discussion about the quality of service. The discussion is not unsubstantiated, in theory, because a firm's incentive to reduce costs could fall hand-in-hand with reduction in the quality of service. However, in reality, studies have found no conclusive evidence that the quality of service deteriorates under the PCR. Additionally, instituting quality regulation, and allowing natural monopolies to operate in competitive markets are associated with mitigating the risk of quality reduction under the PCR. Notably, the USPS is engaged in both. As a result, consumers do not face quality deterioration due to the current price cap regulation.

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<sup>72</sup> As opposed to Rate of Return Regulation (ROR), for instance. Over the past few decades regulators have shifted from ROR to PCR, specifically in the electricity and telecommunications sectors. See, for example, Sappington and Weisman, 2016.

<sup>73</sup> See, for example, Eckenrod, 2006 and, Iozzi et al., 2002.

We examine the impact of the price cap regulation on the quality of service in several key industries where natural monopolies are common such as telecommunications, electricity, and the postal service itself. Additionally, we look at the issues behind service quality issues experienced by USPS and how the Postal Accountability and Enhancement Act (PAEA) requirement to measure performance in has motivated the USPS to improve service quality for consumers. Our findings are divided into the following sections:

1. Literature Review Findings.
2. USPS Service Quality Issues.
3. PAEA and USPS Service Quality Improvements.

## Key Findings

1. **Literature Review Findings.** The academic literature has the following findings (a) there is no conclusive evidence the incentive regulation causes reductions in the quality of service; (b) quality regulation is often paired with benchmarking requirements to address concerns about quality deterioration and; (c) firms that operate in competitive markets are less likely to consider reductions in the quality of service. These findings are detailed below.
  - a. There is no conclusive evidence the incentive regulation causes reductions in the quality of service.
    - i. While there is no competition for market dominant products under the price cap regulation, firms still have incentive to provide quality service in order to increase sales. Quality deterioration not only lowers costs but also reduces the demand of the product or service. As a result, a utility company faces a tradeoff between cost savings and potential loss of sales.<sup>74</sup>
    - ii. In the U.S. telecommunications industry where the price cap regulation exists, evidence shows that the industry accelerated efforts to modernize the network.<sup>75</sup> These efficiencies are passed on to the consumer in terms of improved service quality.
    - iii. Several research studies have found tradeoffs in terms of quality improvements for regulated firms. In the U.S. telecommunications industry, the results are mixed. Research found some aspects of quality such as installation time and customer satisfaction improved while others factors such as repair times declined.<sup>76</sup> These mixed findings illustrate the complexity in assessing consumer preferences in terms of quality.
    - iv. Numerous academics have come to the same conclusion that there is no conclusive evidence to demonstrate a decline in the quality of service under the price cap regulation. Several sound bites include:
      1. “[There] is little empirical evidence to support the contention that quality under price caps has actually deteriorated.”<sup>77</sup>

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<sup>74</sup> Vogelsang, Ingo. 2002. Incentive Regulation and Competition in Public Utility Markets: A 20 Year Perspective. *Journal of Regulatory Economics*; 22:1 5-27, pp 11.

<sup>75</sup> Vogelsang, Ingo. 2002. “Incentive Regulation and Competition in Public Utility Markets: a 20 Year Perspective.” *Journal of Regulatory Economics*; 22:1 5-27. pp 11.

<sup>76</sup> Ai, Chunrong, Salvador Martinez, and David E.M. Sappington. 2004. “Incentive Regulation and Telecommunication Service Quality.” *Journal of Regulatory Economics*; 26:2 263-285.

<sup>77</sup> Vogelsang, Ingo. 2002. “Incentive Regulation and Competition in Public Utility Markets: a 20 Year Perspective.” *Journal of Regulatory Economics*; 22:1 5-27

2. “Studies confirm the lack of a systematic relationship between the PCR and service quality.”<sup>78</sup>
  3. “First, the empirical research to date does not provide unequivocal findings regarding the effects of incentive regulation on the quality of service. Indeed, there is no single dimension of service quality on which all of the studies provide the same qualitative finding. Second, for many dimensions of service quality and many types of regulatory regimes, the empirical research to date identifies no significant impact of regulatory policy on telephone service quality.”<sup>79</sup>
  - b. Quality regulation is often paired with benchmarking requirements to address concerns about quality deterioration. Some regulations require the release of service quality metrics. Increased dissemination of information regarding compliance with service quality benchmarks, e.g., via website postings, media announcements, and bill inserts, provides the regulated firm with incentives to increase investment in quality.<sup>80</sup> So, even a small increase in dissemination will increase quality of service for the measured benchmarks.
  - c. Firms that operate in competitive markets are less likely to consider reductions in service quality. In order to maximize profits in a regulated firm’s competitive products portfolio, it is necessary to maintain good service quality for non-competitive products. In other words, if consumers are unhappy with the quality of service for non-competitive products, they are unlikely to seek out the firm to purchase its competitive products.
    - i. For example, while local exchange telephone companies are subject to price regulation for local telephone service, those firms also participate in complementary, competitive markets, including long distances, wireless, and Internet access. A reputation of poor quality of a local exchange telephone service will have adverse spillover effects on the complementary markets, wherein customers have ample choice of service providers and customer switching costs are minimal.
- 2. USPS Service Quality Issues.** The USPS structure has key elements to protect against quality deterioration including requirements to measure performance and the ability to participate in competitive markets for non-competitive products. However, there has been evidence of quality issues, especially in 3 to 5 day delivery. These issues are not due to the price cap but rather due to internal decisions on network realignment and weather issues.
- a. The USPS identified three main reasons for missing service performance goals in 2014 and 2015.
    - i. Network changes due to realignment have impacted performance. According to the USPS: “creating efficient in processing that resulted in complement shifts and initially impacted our ability to achieve targets.”<sup>81</sup>
    - ii. Personnel changes due to realignment have impacted performance. Network realignment includes moving from career to non-career workers. According to the USPS: “We have missed serval year’s targets for service due to an aggressive work

<sup>78</sup> Sappington, David E.M., and Dennis Weisman. 2010. “Price Cap Regulation: What Have We Learned from Twenty-Five Years of Experience in the Telecommunication Industry,” pp. 16.

<sup>79</sup> Sappington, David E.M. 2003. “The Effects of Incentive Regulation on Retail Telephone Service Quality in the United States.” *Reveiw of Network Economics*. 2:3, 355-375. pp. 356.

<sup>80</sup> Weisman, Dennis L. 2005. *Price Regulation and Quality*. Information Economics and Policy 17 pp. 165-174, June 11, pp. 166.

<sup>81</sup> United States Postal Service. 2015. *Annual Report to Congress, FY2015*, pp. 10.

hour stretch and the hiring, training, and replacement (due to turnover) of many new employees.”<sup>82</sup>

- iii. Weather has impacted performance by delaying delivery of mail due to poor travel conditions.<sup>83</sup>

- b. Network realignment was initiated because of issues unrelated to the price cap. Because the USPS notes that primary controllable (not weather-related) issues with service quality are due to network realignment, it is important to note that the network realignment was not a result of the price cap. Instead, network realignment was based on internal decisions made the USPS to address financial concerns due to decline in mail volume and the retirement prefunding benefit requirements. Some evidence of the causes for USPS financial issues are below:

- i. Testimony of David E. Williams on behalf of the USPS regarding Mail Processing Network Rationalization Service Changes, 2012: “Economic recession has combined with a precipitous and largely irreversible decline in First-Class Mail volume to change the mail mix significantly and reduce revenues that have historically funded the lion's share of cost for operating the mail processing network. These volume declines have resulted in an acceleration of excess capacity in the Postal Service’s mail processing and transportation networks. At the same time, additional statutorily mandated costs coupled with the revenue declines have resulted in unsustainable yearly financial losses.”<sup>84</sup>
- ii. Testimony of Stephen Masse on Exigent Request, 2010: “The current business model has historically assumed that increasing revenue from growing mail volume will cover the increasing costs of an ever expanding delivery network. When volumes decline, it is impossible for the Postal Service to reduce its costs commensurately because of the high level of fixed costs associated with the massive delivery network, Combine these economics with the additional burden of prefunding the PSRHF by approximately \$5.5 billion annually, and the business model is in a dire state.”<sup>85</sup>

- 3. **PAEA and USPS Service Quality Improvements.** The USPS is required to collect and disseminate information on performance through the Postal Accountability and Enhancement Act of 2006 (PAEA). Specifically, the PAEA requires the USPS to have a mail measurement system for all market dominant products. This system can aid in identifying areas of inefficient mail handling and use that greater visibility to help correct service problems. This system has been effective in both regards.

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<sup>82</sup> United States Postal Service. 2014. Annual Report to Congress, FY2014, pp. 38.

<sup>83</sup> United States Postal Service. 2015. Annual Report to Congress, FY2015, pp. 10; Notably, PRC recommends differentiating weather related service issues from ongoing service issues for districts who do not meet performance targets. Appendix: Commission Findings and Recommendations of the Analysis of the USPS FY2015 Performance Report and FY2016 Performance Plan.

<sup>84</sup> Postal Regulatory Commission. 2012. Mail Processing Network Rationalization Service Changes, 2012. Direct Testimony of David E. Williams on Behalf of the Postal Service (USPS-T-1). Docket No. N2012-1, pp. 4.

<sup>85</sup> Postal Regulatory Commission. 2010. Exigent Request, 2010. Statement of Stephen J. Masse on Behalf of the Postal Service. Docket No. R2010-4, pp. 5-6.



- a. It has been found that the PAEA may have helped to prevent reductions in service quality by including requirements to measure service quality.<sup>86</sup> Benchmarking metrics encourages improvements in performance. While the USPS does not always meet its targets, it has still continued to show improvements in service quality. The most recent USPS quarterly performance report for Single-Piece First-Class Mail<sup>87</sup> reported the following findings:
  - i. Two-Day performance improved for all 7 areas and for 60 out of 67 districts compared to the same period last year. Nationally, Two-Day performance was 1.5 points higher compared to the same period last year.
  - ii. Three-To-Five-Day performance improved across every district and area compared to the same period last year. Nationally, Three-To-Five-Day performance was 10.8 points higher compared to the same period last year.
- b. USPS is moving towards an improved system that will better measure performance and improve quality of service for consumers. After identifying weaknesses in the current performance system, USPS developed its own internal system that incorporates new technology to more accurately and efficiently measure service performance for all types of mail. This system will improve service quality for consumers because it will provide USPS will data needed to provide consistent, reliable and predictable service. Additionally, USPS will be able to provide real-time mail visibility, tracking and performance metrics which can help businesses plan mailings, measure success of mailing campaigns, and efficiently staff operations.<sup>88</sup> Finally, this improved system will better help USPS identify and, subsequently, address service performance issues.

## Closing Remarks

While the USPS is subject to price constraints, the PCR does not reduce service quality for consumers. The USPS has incentive to offer quality service for its non-competitive products in order to maximize revenue for its competitive products. Furthermore, to ensure quality service, the USPS has standards in place to identify areas with performance issues and encourage continuous improvements in service quality. These metrics are assessed annually and are publicly available. The requirement helps to identify service issues and ultimately allow the USPS to make adjustments and improve quality. These findings support the conclusion that customers are not negatively impacted by, and in fact, benefit from the price cap regulation in sectors with natural monopolies, like the postal service.

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<sup>86</sup> Ravnitzky, Micheal J. 2014. "Postal Price Cap Regulation: United States Experience since 2006." Presented at the Rutgers Univ. Center for Research in Regulatory Industries Eastern Conference, Shawnee on Delaware, Pennsylvania, May 14-16. Available at [www.prc.gov](http://www.prc.gov).

<sup>87</sup> United States Postal Service. 2016. Quarterly Performance for Single-Piece First-Class Mail, Mailpieces Delivered Between 04/01/2016 and 06/30/2016.

<sup>88</sup> United States Postal Service. 2015. Annual Report to Congress, FY2015, pp. 30.

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## Summaries of Academic Articles

Below is a summary of each article referenced in the paper. The summary is extracted directly from the abstracts. Several additional details are added to the abstracts to highlight key findings related to service quality and price cap regulation.

### **Incentive Regulation and Telecommunication Service Quality**

Ai, Chunrong, Salvador Martinez, and David E.M. Sappington (2004)

This paper examines the impact of incentive regulation—price regulation and earnings sharing regulation—on retail service quality in the U.S. telecommunications industry between 1991 and 2002. It finds that some areas of service quality improve, while others decline. Specifically, incentive regulation is associated with significantly higher service quality on several dimensions (e.g., more rapid installation of new telephone service, fewer trouble reports, and increased customer satisfaction) but significantly lower quality on some dimensions (fewer installation commitments met and longer delays in resolving reported service problems).

### **Incentive Regulation in Local Telecommunications: The Effects of Price Markups**

Sarah B. Eckenrod (2006)

This paper explores the impact of price mark ups due to the price cap regulation. The markup occurs because the regulated firm will maximize the price of its goods (i.e., will price at the price cap), and reduce cost savings to maximize profits. Research shows that while a markup does exist, the cost savings will be passed down to the consumer in the form of lower prices over time, and both the regulated firm and the consumer are better off.

### **Social Preferences and Price Cap Regulation**

Iozzi, Alberto, Jonathan A. Portiz, and Edilio Valentini (2002)

The paper finds that price caps have desirable properties in terms of allocative efficiency. Price caps force prices towards the “Ramsey price” or the price a monopoly should set to maximize social welfare. Social welfare is the sum of consumer surplus and the firm’s profits, provided that the firm is able to obtain a given amount of profits. The paper finds that in all scenarios, especially under Laspeyres-type price regulation, price caps ensures convergence towards prices that maximize social welfare.<sup>89</sup>

### **Postal Price Cap Regulation: United States Experience Since 2006**

Michael J. Ravnitzky (2014)

The paper compares the USPS price cap to theoretical price cap regulation, and actual price cap regulation in other industries or countries, and, in doing so, identifies and describes issues with the USPS price cap. However, it is not critical of the general concept of the price cap, instead, the author discusses challenges with its implementation, and highlights areas of uncertainty due to vagueness in the regulation, such as the treatment of deflationary periods for rate adjustments and the classification of new products as market dominant or competitive. Ultimately, the paper concludes that price cap regulation has helped USPS to improve productivity and efficiency, reduce work hours, and improve service performance reporting. While the financial position of USPS are serious, and require action, these issues are not direct results of the price cap regulation.

### **The Effects of Incentive Regulation on Retail Telephone Service Quality in the United States** Sappington (2003)

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<sup>89</sup> The USPS Price Cap is based on Laspeyres-type price regulation.

This paper provides a review and critique of the empirical literature that examines the effects of incentive regulation on retail telephone service quality in the United States. The literature provides mixed findings. Some dimensions of service quality appear to improve under incentive regulation (relative to rate of return regulation) while others deteriorate.

### **Price Cap Regulation: What Have We Learned from Twenty-Five Years of Experience in the Telecommunications Industry?**

David E. M. Sappington and Dennis L. Weisman (2010)

This paper provides a comprehensive review of the impact of incentive regulation in the telecommunications industry from 1984 forward. The paper compares the pros and cons of rate of return (ROR), price cap regulation (PCR), and earnings sharing regulation (ESR). The findings show a clear shift in regulatory preferences from ROR and ESR to PCR over time at that state level. The authors note that PCR has potential to have adverse effects on quality because the regulated firm is bound by the price cap and cannot capture the full increase in surplus produced by an increase in service quality. As a result, PCR is often complemented with quality regulation. Quality regulation may set standards for performance or require record keeping of customer complaints and analysis of reoccurring issues. A firm whose performance is sub-par could be penalized formally (e.g. through financial penalties), or informally (e.g., reduction of political capital on other policy matters). Measuring quality is a complex issue, because of variations in definitions of quality, preferences on tradeoffs (e.g., service quality vs. cost), and root cause of quality issues (e.g., was the service issue a product of the firm itself or an external factor which is out of the control of the firm). A literature review demonstrates that perceived systematic issues on quality deterioration under PCR are unsubstantiated.

### **Incentive Regulation and Competition in Public Utility Markets: a 20 Year Perspective**

Vogelsang, Ingo (2002)

This paper examines the use of price caps to regulate monopolies, and subsequently examines the impact of price caps on service quality and allocative efficiency. While price caps have been blamed for reducing quality, in reality, the regulated monopoly has incentive to maintain quality service for its customers. Quality deterioration reduces demand and has potential to spur competition. Consequently, the utility faces a tradeoff between cost savings and a potential loss of sales. Literature shows that there is no conclusive evidence that price cap regulation reduces demand.

### **Price Regulation and Quality**

Dennis L. Weisman (2003)

The paper explores the impact of the price cap regulation on service quality. There are five primary findings: 1) Holding all other factors equal, a firm's incentive to invest in service quality increases with the level of the price cap; 2) the incentive to reduce investment in quality under price regulation may be tempered by the regulated firm's participation in complementary, competitive markets; 3) revenue-share penalties may actually provide the regulated firm with incentives to reduce investment in service quality; 4) profit-share penalties provide the regulated firm with unambiguous incentives to increase investment in service quality and; 5) increased information dissemination concerning compliance with service quality benchmarks provides the regulated firm with incentives to increase investment in quality.

Postal Regulatory Commission Docket No. RM2017-3

## INITIAL COMMENTS OF THE GREETING CARD ASSOCIATION – APPENDIX C

### Are USPS Price Elasticity Estimates Capable of Predicting USPS Revenues and Consequently Postal Pricing and Regulation?

This paper analyzes the following question: Are USPS price elasticity estimates capable of predicting USPS revenues and consequently postal pricing and regulation?

The answer is no. The USPS price elasticity estimates are not capable for predicting USPS revenues and consequently postal pricing and regulation. The price elasticity estimates fluctuated substantially and the USPS econometric models are criticized with many caveats. The USPS econometric models are sufficient and adequate for explaining the past but are not necessarily reliable for predicting USPS revenues.

## Question: Are USPS price elasticity estimates capable of predicting USPS revenues and consequently postal pricing and regulation?

The USPS estimates the elasticity of its market dominant products on an annual basis, and submits its findings to the Postal Regulatory Committee (PRC). While the USPS elasticity model may provide insights into historical demand, it is not fit to be used for predictive purposes both because the model produces inconsistent results and the USPS classifications in the model continue to change. Additionally, as consumer preferences and economic conditions continue to change, it is increasing difficult to predict changes in demand. As a result, using USPS elasticity estimates alone is an insufficient means of predicting demand for USPS mail services.

### **USPS econometric results are inconsistent and unreliable for predictive purposes**

We reviewed USPS narratives on elasticity submitted to the PRC from 2007-2015. Table 1 below reproduces own-price elasticity estimates produced by the USPS in these years. Each year the USPS uses the most recent five years data to estimate the demand functions for USPS mails. These own-price elasticity estimates are based on five-year rolling data from 2003-07 to 2011-2015. The shortcomings of USPS price elasticity estimates are categorized in four categories: changes in elasticity values, fluctuations in magnitude, inconsistent product groupings, and variations in modeling. These shortcomings render the estimates unfit for predictive purposes.

1. **Changes in elasticity values.** The USPS model generated estimates that change from price inelastic to price elastic in a year. For example, Workshared Cards fluctuate from being price inelastic in 2007 and 2008 (0.5 and 0.8, respectively) to price elastic in 2009 and 2010 (1.4 in both years) and then inelastic again in 2011 (0.3) (Table 1). In its 2013 report, the Office of Inspector General (OIG) notes that USPS year-to-year fluctuations in the USPS's price elasticities are not recent phenomenon.<sup>90</sup> However, the USPS OIG dismisses any significance of these fluctuations. In practice, this inconsistency makes it difficult to assess the impact of change in price on demand and therefore pricing policies. If the USPS used the own-price elasticities in 2007 and 2008 (0.5 and 0.8, respectively), the USPS would expect to have higher revenues in 2009 and 2010 by raising First-Class Workshared Card prices. However, the USPS revenues actually would decline in 2009 and 2010 because the own-price elasticities were 1.4 in both years.
2. **Fluctuations in the magnitude of estimated values.** The price elasticity estimates fluctuated on a yearly basis. While small changes are reasonably expected, there are instances

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<sup>90</sup> USPS Office of the Inspector General. 2013. Analysis of USPS Price Elasticities. May 1.

where the magnitude fluctuated by 75% or more from year to year. The fluctuation has a significant impact on the forecast and pricing policy implications. For instance, the own-price elasticity estimate of First-Class Single Piece Cards was 0.12 in 2008 but then increased by three times to 0.40 in 2009 (Table 2.1). In the plain English, a 1% increase in USPS price could result in a 0.12% decrease or a 0.40% decrease in volume, depending on which estimate is used. In 2015, the volume of First-Class Single Piece Cards was about 839 million pieces. If USPS used the low own-price elasticity estimate, the volume of First-Class Single Piece Mail is expected to drop by less than 1 million pieces (839 million pieces x 0.12%) resulting from a 1% increase in price. However, if USPS used the higher own-price elasticity estimate, the volume of First-Class Single Piece Cards is expected to decline by more than 3.3 million pieces (839 million pieces x 0.40%) resulting from a 1% increase in price.

**Table C.1**  
**Own-Price Elasticity Estimates of First Class and Standard Mail, 2007-2015<sup>91</sup>**

	2007	2008	2009	2010	2011	2012	2013	2014	2015
<b>First-Class Mail</b>									
Single Piece Letters, Flats, Parcels	0.23	0.22	0.19	0.18	0.19				
Workshared Letters, Flats, Parcels	0.25	0.25	0.44	0.35	0.44				
Single Piece Letters, Cards						0.09			
Single Piece Flats						0.27			
Single Piece Letters, Cards, Flats							0.16	0.14	0.15
Workshared Letters, Cards, Flats						0.39	0.34	0.31	0.32
Single Piece Cards	0.11	<b>0.12</b>	<b>0.40</b>	0.25	0.06				
Workshared Cards	0.53	<b>0.84</b>	<b>1.43</b>	<b>1.40</b>	<b>0.29</b>				
International Letters, Cards, Flats							0.39	0.08	0.10
<b>Standard Mail</b>									
Regular	0.37	0.31	0.24	0.29	0.34	0.44	0.46	0.48	0.44
Enhanced Carrier-Route	0.71	0.91	0.84	0.73	0.78	0.70	0.89	0.85	0.82

<sup>91</sup> USPS Demand Model Narratives submitted to PRC, 2007-2011.



3. **Inconsistent product groupings.** In order to be a good predictive model, the mail groupings should be consistent over time to test its predictive power. However, the USPS frequently changes its product groupings. As such, the elasticity estimates cannot be compared over time. From 2011 to 2015, the USPS changed the groupings of First-Class Single Piece Letters three times. During the period between 2007 and 2011, the USPS combined Single Piece Letters, Flats, and Parcels into one group. In 2012, Single Piece Letters and Cards were combined in one group. From 2013 to 2015, the USPS changed one more time to have Single Piece Letters, Cards, and Flats in one group. These changes in grouping make the econometric results incomparable, and cannot be used as evidence that the USPS estimates are reliable.
4. **Frequent variation in modeling.** The USPS changes the drivers (or explanatory independent variables) in its demand model from year to year. For instance, the USPS included a variable for Internet in 2007 and 2008 but then removed it in 2009. Similarly, a dummy variable was included for forever stamps in the 2009 model but not in other years.<sup>92</sup> These changes can impact the own-price elasticity estimates. In its report, the Office of the Inspector General also noted that frequently changing these drivers make it difficult to assess changes in consumer behavior.<sup>93</sup> Modeling the pattern of consumer behavior is an important component in forecasting, especially for the USPS; consumer preferences related to mail are changing, as seen through continued volume decline due to e-diversion.<sup>94</sup>

## USPS elasticity estimates are insufficient for forecasting

The USPS uses volume forecasts to determine business decisions, especially as it relates to pricing. Therefore, it is imperative that the USPS uses a forecast model that is reasonably accurate and reliable. The consequences of decisions made based on the forecasts, such as changes in price to achieve the targeted revenue, are often irreversible. While it was previously acceptable to forecast mail volumes using historical data and econometric models, significant changes in the mail market have made the forecast more complex and subject to much more uncertainty.<sup>95</sup> As a result, the USPS elasticity estimates should not be used as the sole determining factor in USPS pricing decisions. Several key issues with using the elasticity estimates for forecasting are as follows:

1. **Some of the decline in mail volume is independent of price.** E-substitution can occur even when prices do not change.<sup>96</sup> As results, the USPS must understand the long run impact of e-substitution in order to have a reliable predictive model.

<sup>92</sup> USPS Demand Model Narratives submitted to PRC, 2007-2011.

<sup>93</sup> USPS Office of the Inspector General. 2013. Analysis of USPS Price Elasticities. May 1.

<sup>94</sup> The USPS 2016 Integrated Financial Plan highlights these changes in consumer behavior stating: "The Great Recession forced a shift in consumer and business attitudes and behaviors that affected their needs for and use of First-Class Mail, together with electronic diversion, First-Class Mail volumes have dropped and will likely continue to drop in 2016."

<sup>95</sup> Feve, Frederique, et al. 2012. Uncertainty and Projections of the Demand for Mail. Multi-modal Competition and the Future of Mail, pp. 77-93.

<sup>96</sup> Veruete-McKay, Leticia, et al. 2013. Electronic Substitution and Postal Price Elasticities: A Customer Market Approach. Reforming the Postal Sector in the Face of Electronic Competition, pp. 226-260.



2. **Price sensitivity varies by sector and segment.** Several sectors are more sensitive to USPS price changes than others. For example, the financial sector is more sensitive to changes in price than the public or utility sectors. Similarly, some mail segments are more price elastic than others. For instance, bills and invoices are more price elastic than contracts. While the USPS estimates First-Class Mail to be very inelastic, research shows that senders of bills, invoices, payments and bank statements are more sensitive to USPS price changes than businesses overall. Within First-Class Mail, these segments were predicted to decline over 40% from 2010 to 2020, while other sectors of mail were predicted to decline only 20-25%.<sup>97</sup>
3. **Price sensitivity increases over time.** Sectors need to develop infrastructure to support alternative methods of communication. This takes time. Research shows that price elasticity increases over time as businesses take time to adjust to changes in the market.<sup>98</sup> As a result, the USPS needs to consider long run impact of pricing on volume.

## Closing Remarks

In short, the USPS elasticity model is unfit for predictive purposes. While it may provide insights into historical demand, the model has limitations due to the variation in values produced from year to year, the groupings of products used, and the variables used in the equations. Even using the most recent estimates, assuming the model produces reliable estimates, current literature warns against basing pricing decisions on elasticity alone because of its inability to assess changing in consumer behavior. With the continued decline of mail volume, it is imperative the USPS base changes in price on the most accurate and reliable forecasting methods.

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<sup>97</sup> Boston Consulting Group. 2010. Projecting Mail Volumes to 2020. <https://about.usps.com/future-postal-service/bcg-detailedpresentation.pdf>

<sup>98</sup> Veruete-McKay, Leticia, et al. 2013. Electronic Substitution and Postal Price Elasticities: A Customer Market Approach. Reforming the Postal Sector in the Face of Electronic Competition, pp. 226-260.

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